Financial Reporting Framework for Small-and Medium-Sized Entities

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Introduction

The depth and breadth of authoritative guidance issued over the past several decades has been staggering. During this same period of time there was essentially one generally accepted reporting framework recognized, "Generally Accepted Accounting Principles (GAAP) or US GAAP", with the Financial Accounting Standards Board (FASB) setting the rules and reporting requirements for both publicly traded companies as well as privately held companies.

There has been a long standing argument regarding whether the mandated requirements under GAAP that are geared toward very large publicly traded companies are relevant to small- and medium-sized privately held companies. Practitioners have been vocal for the need of "Big GAAP" and "Little GAAP" knowing that the cost of implementing some of the reporting requirements in certain cases can greatly outweigh the benefits of complying with those requirements for privately held companies and do not necessarily provide any additional insights or benefits to the users of the financial statements that would influence the conclusions reached regarding those financial statements for small and medium privately held companies.

As of the beginning of this year, the other non-US GAAP reporting frameworks available were limited to cash or modified cash basis, income tax basis and other statutory driven frameworks that have limited availability to narrow ranges of entity types. Collectively, these reporting frameworks are now commonly known as special purpose frameworks (SPFs).

Financial Reporting Framework (FRF) for Small-and Medium-Sized Entities (SME)

On June 10, 2013, the AICPA issued FRF for SMEs which is a self contained SPF that is similar in many respects to GAAP but is a comprehensive basis of accounting other than GAAP. This framework is the most similar to US GAAP of the SPFs that are currently issued. The complete self-sustained guide is available on the AICPA's website at the following link:
http://www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/PCFR/DownloadableDocuments/FRF-SME/FRF-SMEs-Framework.PDF

FRF for SMEs has the objective of providing thorough, relevant, and robust financial information in a user friendly format without some of the complications and requirements noted in current US GAAP.

Major Differences between FRF for SMEs and US GAAP

US GAAP Topic	FRF for SMEs
Business Combinations	• As of the acquisition date, the acquirer should recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquire. Identifiable assets acquired and liabilities assumed are measured at the acquisition date market values. Exceptions exist. • An entity should make an accounting policy choice to account for an intangible asset acquired in a business combination either by separately recognizing the intangible asset as an identifiable asset or by not separately recognizing the intangible asset as an identifiable asset and subsuming into goodwill the value of the intangible asset.
Comprehensive Income	• No concept of comprehensive income or items of other comprehensive income.
Consolidations/ Subsidiaries	• Policy choice to either consolidate subsidiaries or account for subsidiaries using the equity method. • Subsidiary is defined as an entity in which another entity owns more than 50% of the outstanding residual equity interests. • No concept of variable interest entities (VIEs) (no FIN 46).
Defined Benefit Plans	• Policy choice to account for plans using either a current contribution payable method or one of the accrued benefit obligation methods.
Derivatives	• Disclosure approach. • Recognition at settlement (cash basis). • No hedge accounting.
Fair Value	• Uses term “market value,” defined as “the amount of the consideration that would be agreed upon in an arm’s-length transaction between knowledgeable, willing parties under no compulsion to act.” • Market Value measurement used only in limited circumstances, such as business combinations, certain nonmonetary transactions, and marketable equity and debt securities held for sale.
Goodwill	• Amortize over the same period used for federal income tax purposes, or 15 years. • No impairment testing.
Impairment	• No assessment of impairments for long-lived assets. • A depreciated or amortized cost approach is followed. Assets no longer used are written off.
Income Taxes	• Policy choice to account for income taxes using either the taxes payable method or the deferred income taxes method. • No evaluation or accrual of uncertain tax positions (No FIN 48).
Industry-Specific Guidance	• Framework does not contain industry-specific guidance; so if an industry has highly specialized accounting requirements, FRF for SMEs may not be appropriate.

US GAAP Topic	FRF for SMEs
Intangible Assets	• All intangible assets are considered to have a finite useful life and are amortized over the estimated useful life. • In accounting for expenditures on internally generated intangible assets during the development phase, management should make an accounting policy choice to either expense such expenditures as incurred or capitalize such expenditures as an intangible asset, provided the criteria are met.
Inventories	• Valued at lower of cost or net realizable value.
Investments/Financial Assets and Liabilities	• Historical cost approach. • Market value measurement required only for investments being held for sale. • Changes in market value included in net income.
Leases	• Traditional accounting approach blended with some accrual income tax methods. • Lessee classifies leases as either operating or capital. • Lessor accounts for leases as sales type, direct financing, or operating.
Push-Down Accounting	• New basis (push down) accounting guidance is provided. • Specific guidance provided on comprehensive revaluation of assets and liabilities under certain conditions.
Revenue Recognition	• Broad, principle-based guidance on revenue recognition. • Revenue should be recognized when performance is achieved and ultimate collection is reasonably assured. • For goods: Performance is achieved when the entity transfers the risks and rewards associated with the goods to a customer. • For services: Performance should be determined using either the percentage of completion method or the completed contract method. Performance should be regarded as having been achieved when reasonable assurance exists regarding the measurement of the consideration that will be derived from rendering the service or performing the long-term contract.
Stock-Based Compensation	• Disclosure only.

Source: Pennsylvania CPA Journal Fall 2013 | Volume 84, Number 3 – written by James J. Newhard, CPA

Circumstances when an Entity may Consider Adopting FRF for SMEs

- The entity does not have regulatory reporting requirements that essentially require it to use GAAP-based financial statements.
- A majority of the owners and management of the entity have no intention of going public.
- The entity is for-profit.
- The entity may be owner-managed, which is a closely held company in which the people who own a controlling ownership interest in the entity are substantially the same set of people who run the company.
- Management and owners of the entity rely on a set of financial statements to confirm their assessments of performance, cash flows, and of what they own and what they owe.
- The entity does not operate in an industry in which the entity is involved in transactions that require highly-specialized accounting guidance, such as financial institutions and governmental entities.
- The entity does not engage in overly complicated transactions.
- The entity does not have significant foreign operations.
- Key users of the entity's financial statements have direct access to the entity's management.
- Users of the entity's financial statements may have greater interest in cash flows, liquidity, statement of financial position strength, and interest coverage.
- The entity's financial statements support applications for bank financing when the banker does not base a lending decision solely on the financial statements but also on available collateral or other evaluation mechanisms not directly related to the financial statements.

Source: AICPA's FRF for SMEs issued on June 10, 2013

Financial Accounting Foundation (FAF) Private Company Council (PCC)

In May 2012, the FAF's Board of Trustees approved the creation of the PCC. The PCC was developed with two overarching responsibilities:

1. Work jointly with the FASB to mutually agree on criteria used to decide whether and when exceptions and/or modifications to GAAP would be prudent for privately held companies. The PCC would review and propose modifications to GAAP on a project by project basis with the goal of addressing the needs of the users of private company financial statements.
2. The PCC would also be involved in reviewing and commenting on the appropriate treatment for private companies for active project under FASB's technical agenda.

   Source: FASB website
   http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1351027243284

Currently there are four projects that the PCC has issued exposure drafts for:

1. PCC Issue No. 13-01A, Accounting for Identifiable Intangible Assets in a Business Combination
2. PCC Issue No. 13-01B, Accounting for Goodwill Subsequent to a Business Combination
3. PCC Issue No. 13-02, Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements
4. PCC Issue No. 13-03, Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps

In addition to these current projects, the PCC is also considering adding additional projects to their agenda to address such concerns as stock based compensation and uncertain tax positions (ASC Topic 740, Income Tax) as two examples.

It appears that the issuance of the AICPA's FRF for SMEs has stimulated the PCC to shorten the response time addressing these projects and others. The PCC exceptions/modifications appear to be the means to the creation of "Little GAAP."

Viability of the FRF for SMEs?

Exceptions or modifications to current US GAAP authorized by the PCC will still be considered GAAP basis financial statements and not a SPF such as FRF for SMEs. This is a key difference between FRF for SMEs and the PCC. In time, the vast majority of the items addressed by the FRF for SMEs will probably be addressed by the PCC. As the differences narrow between PCC's version of US GAAP and FRF for SMEs SPF framework, the benefits of following FRF for SMEs will also diminish.

When considering whether to adopt FRF for SMEs companies also need to consider the other potential impacts. Those impacts include but are not limited to the following:

- Potential impact and effort needed to negotiate and re-write loan documents, covenants, and other lending instruments to adjust the verbiage to allow for non-US GAAP based financial statements.
- Educational costs needed for management to get up-to-speed on the FRF for SMEs guidance.
- Additional diluting factors:
  - Since FRF for SMEs is a SPF that is similar to US GAAP, the effort needed to comply with the SPF will be significantly closer to the effort required to generate US GAAP based financial statements than income tax basis or modified cash basis financial statements.
  - Chapter 3 of the of AICPA's FRF for SMEs discusses how the transition from US GAAP to this SPF should be handled. Key points to consider include:
    - Preparation of an opening statement of financial position (balance sheet) where all assets and liabilities that should be included under the framework are and those that should not be are excluded and the impact of the exclusions are addressed and or reclassified as needed.
      - There are exemptions from the first bullet for the following items:
        - Business combinations
        - Financial assets and liabilities
        - Asset retirement obligations
      - If those exemptions are chosen by management then they have to follow those policies on a go-forward basis.
    - Additional footnotes to explain changes in equity based on the adoption of FRF for SMEs along with other disclosures addressing any exemptions elected by the company when adopting the FRF for SMEs SPF

Illustrative Financial Statements under FRF for SMEs

See the link below for the AICPA's Illustrative Financial Statements Prepared Using the Financial Reporting Framework for Small-and Medium-Entities.
http://www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/PCFR/DownloadableDocuments/FRF-SME/FRFforSMEs_Illustrative_Financial_Statements.pdf