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THE AICPA'S FINANCIAL REPORTING FRAMEWORK FOR SMALL- AND MEDIUM-SIZED ENTITIES—AN UPDATE

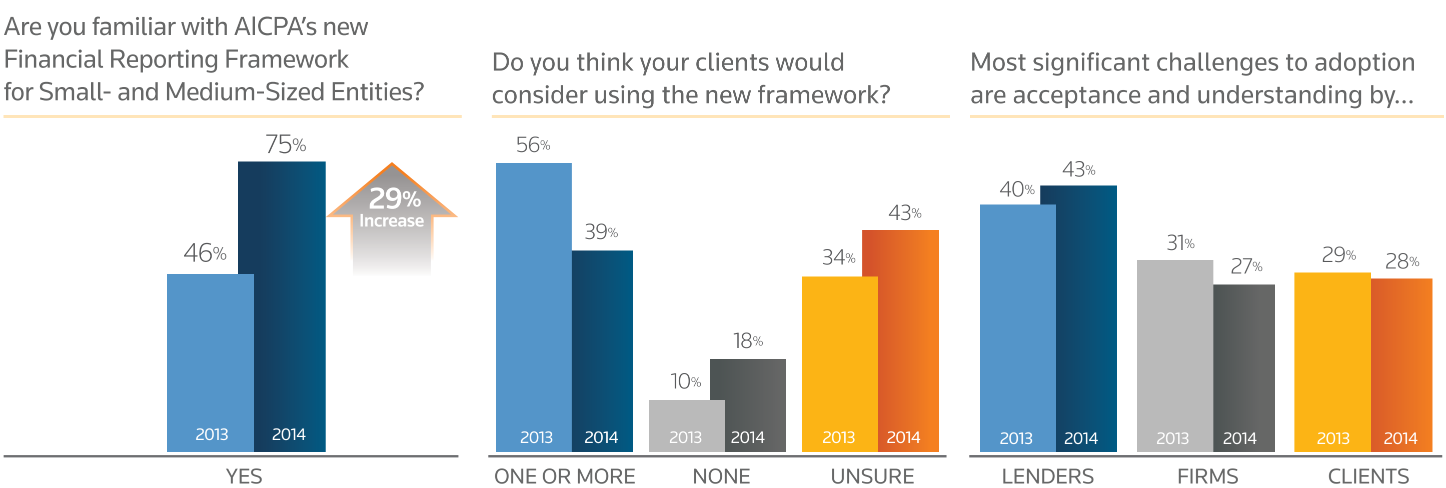
JULY 2014

A year has now passed since the AICPA issued its new, optional reporting framework for small- and medium-sized entities. At that time, we at Thomson Reuters issued our Special Report on the Framework, in which we shared data and insights regarding expected use. We are now providing this update to share with you where we see things today. We hope that you find this information to be useful and valuable as you consider how this new Framework might meet the needs of your clients.

The Framework is titled the "Financial Reporting Framework for Small- and Medium-Sized Entities," and is often referred to as the "FRF for SMEs™." In this report, we also refer to it as the "Framework."

As expected, initial adoption of the Framework has been modest, and firms will most likely move to it incrementally depending on their unique client situations. This probably comes as no surprise to some who were initially critical of the Framework and its objectives. But the key question remains, "Are there particular entities and users of financial statements that could benefit from adoption of this Framework?" In this Update to our Special Report, we will share the results of our recent customer survey, summarize differences between it and GAAP, consider changes to GAAP over the past year that may impact the Framework's use, and provide further insight into potential benefits to using the Framework.

RECENT SURVEY OF ACCOUNTING PROFESSIONALS*



* Based on surveys from the Tax & Accounting business of Thomson Reuters in May 2013 and 2014.

RESULTS OF THOMSON REUTERS RECENT SURVEY

The Tax & Accounting business of Thomson Reuters surveyed customers about the new Framework in May 2013 and again in May 2014, to gauge changes in perception over the past year.

In 2013, 46% of the 213 respondents were familiar with the new Framework, compared to the 2014 results where 75% of the 318 respondents were familiar with the Framework. Thus, awareness grew by approximately 29%.

In 2013, of those who were familiar with the Framework, 56% expected that one or more of their clients would consider using the Framework, while 10% said they did not expect their clients to use the Framework, and 34% were unsure. In 2014, those percentages changed to 39% who expected one or more of their clients to consider using the Framework, 18% who did not expect their clients to use the Framework, and 43% who were unsure. So while a significant percentage of respondents (39%) still expect the Framework to be used, the number who are unsure or do not expect usage has increased.

Finally, we asked what the biggest challenge is expected to be for acceptance of the Framework. In 2013, 40% believed that acceptance by lenders was the biggest challenge, followed by 31% who thought it was acceptance and understanding by the firm, and 29% who believed it was acceptance by clients. In 2014 the responses were very similar, with 43% believing that acceptance by lenders or other third-party users of financial statements is the biggest challenge; 28% thinking it is acceptance by clients, and 27% believing it is acceptance and understanding by the firm.

HOW ENTITIES AND PRACTITIONERS ARE CURRENTLY RESPONDING

As was expected, responses during the first year have been mixed. Some who were initially skeptical about the benefits of the Framework have changed their minds, and some who initially saw potential value have softened their enthusiasm. And others are just as enthusiastic about its use as they were when the Framework was issued.

Some practitioners have recognized specific opportunities for the Framework to provide value and have taken a very proactive approach by introducing the Framework to their clients and the users of their financial statements. In a recent blog posted by Rodney E. Rice, CPA, a partner in RubinBrown's Assurance Services Group (http://blog.aicpa.org/2014/02/a-firms-strategy-for-offering-the-frf-for-smes-framework-to-clients.html#sthash.wBJ4htHD.dpbs), Mr. Rice explains how his firm began introducing the Framework to clients and other interested parties. RubinBrown found it more beneficial to first explain the FRF for SMEs to their clients' bankers before explaining it to their clients. They began inviting bankers to meetings where they explained the Framework and some of the benefits it offered over GAAP, and then they encouraged them to revise their credit agreements so that borrowers could submit non-GAAP financial statements. After that, they began identifying potential clients that might benefit from converting to the Framework and started meeting with those clients to discuss the new alternative.

The banking industry has also started to provide information on the FRF for SMEs to its members. The March 2014 edition of the American Bankers Association Banking Journal (http://www.nxtbook.com/nxtbooks/sb/ababj0314/#/14) contained an article titled "New Accounting Framework Useful Tool for Lenders." The article indicated that the new accounting Framework could be a competitive tool for banks and encouraged lenders to be aware of the Framework to avoid being at a competitive disadvantage in prospecting for business in the small- and medium-sized entity niche. The article explains that bankers can discuss with its borrowers the availability of the new option and assist them in using it as a way to save costs or to improve financial reporting.

Other practitioners are taking a "wait and see" approach before talking with their clients and the financial statement users about the Framework. The primary reason is that they have been encouraged by the progress of the Private Company Council (PCC) and Financial Accounting Standards Board (FASB) in the past year, and they feel that the related changes to GAAP are very positive for small- and medium-sized entities. These practitioners are willing to wait a little longer to see what other GAAP changes the PCC might instigate on behalf of private companies before discussing with clients a conversion to the FRF for SMEs.

OBSERVATION: The Framework has also been a topic at many national and state conferences and other CPE courses. We expect that trend to continue during this summer's conference and CPE season.

SPECIAL PURPOSE FRAMEWORKS USED MOST OFTEN BY SMALL- AND MEDIUM-SIZED ENTITIES:

INCOME TAX BASIS
Designed to account for transactions according to positions taken for filing with taxing authorities, which are not always designed to account for their economic substance.

PURE CASH BASIS
Designed to account for transactions based only on when they affect cash.

MODIFIED CASH BASIS
Even though modifications of the pure cash basis are required to conform with GAAP, the basis is designed primarily to account for transactions according to when they affect cash.

BACKGROUND ON THIS FRAMEWORK

Most preparers and users of private company financial statements would agree that the financial reporting needs of small- and medium-sized entities are unique. The financial statement users of those types of entities, which are often bankers and sureties, generally have direct access to management. That direct access to management can provide an enormous benefit to the users by answering questions and offering further insight into the business and its operations. As a result of that direct access, some current GAAP financial reporting and disclosure requirements are not as relevant for private companies as for public companies and can sometimes require significant time and effort to address. Thus, a private entity often struggles between the following options:

- Spending the additional time and money required to prepare GAAP financial statements, even though the users of those statements may not need all of the information required by GAAP;
- Preparing its financial statements with one or more departures from GAAP, which may create lending issues because of the departure; or
- Preparing its financial statements in accordance with a special purpose framework (also referred to as an other comprehensive basis of accounting or OCBOA) because of the efficiencies that may be achieved due to fewer complexities.

Other than GAAP, there are three commonly-used financial reporting frameworks available to small- and medium-sized entities: the income tax basis, the cash basis, and the modified cash basis. Each of those frameworks has objectives that differ from the objective of GAAP, and each presents its own advantages and disadvantages.

In an effort to propose a solution to the issue of differing objectives, the AICPA issued the FRF for SMEs to provide small- and medium-sized entities another alternative to GAAP. A stated objective of the Framework is to account for transactions according to their economic substance, which is the same objective as GAAP.

The AICPA explains that the FRF for SMEs is a self-contained framework that was created to "help owner-managed businesses provide relevant, streamlined reporting for users of their financial statements." As with GAAP, historical cost is the primary measurement basis. However, while recurring and nonrecurring adjustments for unrealized changes in value are required in certain situations, those circumstances are more limited than the conditions requiring adjustments in GAAP. There are also several similarities to the accrual income tax basis. For some accounting policies, the Framework allows alternatives so that small- and medium-sized entities can select the policy they believe best meets the needs of their financial statement users.

OBSERVATION: One example of the alternatives allowed by the FRF for SMEs in selecting accounting policies is found in accounting for start-up costs. Entities have the option of expensing start-up costs as incurred or capitalizing and amortizing them over 15 years, while GAAP requires that they be expensed as incurred.

WHAT IS THE DEFINITION OF AN SME?

An entity may choose whether to adopt the Framework. When evaluating that option, the entity might question whether it meets the definition of an SME. First, the Framework does not define a small- and medium-sized entity, and there are no size thresholds to be met for an entity to be considered an SME. Second, an entity may be incorporated or unincorporated. Following are some other characteristics included in the Framework of entities that would be considered SMEs, although this list is not all-inclusive and the criteria are not required to be met:

CHARACTERISTICS OF A SMALL- AND MEDIUM-SIZED ENTITY

- ✓ The entity is not required to prepare GAAP-based financial statements.
- ✓ The entity has no plans of going public in the foreseeable future.
- ✓ The entity is a for-profit entity.
- ✓ The owner(s) of the entity is also the person(s) who runs the entity.
- ✓ There is no highly-specialized accounting guidance for the industry in which the entity operates. (For example, financial institutions and governments have highly-specialized accounting guidance and would not meet that criterion.)
- ✓ There are no overly complicated transactions.
- ✓ There are no significant foreign operations.
- ✓ The financial statement users have direct access to management.

The following table presents the differences between GAAP and the FRF for SMEs that we consider to be most significant.

DIFFERENCES BETWEEN GAAP AND THE FRF FOR SMALL- AND MEDIUM-SIZED ENTITIES

ACCOUNTING AREA	FRAMEWORK TREATMENT	GAAP TREATMENT
Accounting for income taxes	Chapter 21 of the FRF for SMEs allows entities subject to income taxes to elect whether to use the taxes payable method or the deferred income taxes method. The taxes payable method only recognizes current income tax assets and liabilities (i.e., the amount that would be payable or receivable as reflected on the income tax return). Uncertainty in income taxes cannot be considered in accounting for income taxes.	GAAP only permits the deferred income tax method. Uncertainty in income taxes must be considered in accounting for income taxes.
Reporting other comprehensive income	The FRF for SMEs does not include the concept of other comprehensive income; rather, the applicable transactions are reported in the income statement.	GAAP requires certain transactions, such as unrealized appreciation/depreciation in the fair value of marketable securities, to be reported as other comprehensive income until realized.
Accounting for intangible assets acquired in a business combination	Chapter 28 of the FRF for SMEs allows entities to choose whether they will separately recognize identifiable intangible assets or not separately recognize them but rather account for them as goodwill.	GAAP requires that identifiable intangible assets acquired in a business combination be separately recognized at the acquisition date.
Amortization of goodwill	Chapter 13 of the FRF for SMEs requires entities to amortize goodwill over a period consistent with that used for federal income tax purposes, or over a period of 15 years if goodwill is not amortized for federal income tax purposes.	GAAP now provides nonpublic entities the option of amortizing goodwill over a period not to exceed 10 years. Assessments for impairment are still required.
Reporting of subsidiaries	Chapter 22 of the FRF for SMEs allows a parent entity to choose whether to consolidate or use the equity method to account for its subsidiaries. However, the same method of reporting must be applied to all subsidiaries. That guidance essentially allows parent-only financial statements.	GAAP does not provide an alternative as all subsidiaries must be consolidated if the parent exhibits control over the entities. GAAP allows parent-only financial statements to be presented only when the entity also presents related consolidated financial statements.
Accounting for and reporting of variable interest entities (VIE)	The new Framework does not include the concept of VIEs. Therefore, it does not require or allow a reporting entity that is the primary beneficiary of a VIE to consolidate the VIE.	GAAP requires a reporting entity that is the primary beneficiary of a VIE to consolidate the VIE. However, with recent changes as described later in this article, if certain criteria are met, a private company lessee now has the option to elect not to apply the VIE guidance in GAAP to a lessor entity.
Accounting for derivatives	Chapter 6 of the FRF for SMEs does not require derivatives to be recorded but their settlement value must be disclosed.	GAAP requires reporting all derivatives at their fair value.
Accounting for leases	Chapter 25 of the FRF for SMEs addresses accounting for leases by both lessees and lessors and allows more judgment in classifying leases.	GAAP includes more stringent tests to determine the proper classification of a lease.
Accounting for stock-based compensation	Chapter 18 of the FRF for SMEs provides that compensation expense should not be recognized when stock is issued to employees in lieu of cash compensation, but it requires certain disclosures.	GAAP requires that compensation expense be recognized at the grant-date fair value of the securities, less any amount paid or to be paid by the employee, and also requires certain disclosures.

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DIFFERENCES BETWEEN GAAP AND THE FRF FOR SMALL- AND MEDIUM-SIZED ENTITIES (Continued from previous page)

ACCOUNTING AREA	FRAMEWORK TREATMENT	GAAP TREATMENT
Accounting for defined benefit plans	Chapter 20 of the FRF for SMEs allows entities with defined benefit plans to elect whether to use the current contributions payable method or one of the accrued benefit obligation methods. The current contributions payable method only reflects expense for the current year's contribution.	GAAP requires the net periodic pension cost, comprised of several different components, to be recognized each year with the overfunded or underfunded status of the plan being recognized on the balance sheet.
Impairment of assets	Chapter 12 of the FRF for SMEs requires a reduction of the carrying amount of inventories for impairment. However, the Framework does not address the need to adjust the carrying amounts of other assets for subsequent impairment. It is therefore not clear whether the need for those adjustments should be considered.	GAAP requires impairment adjustments for loans and accounts receivable, inventories, and intangible and other long-lived assets.
Recurring adjustments for changes in the value of debt and equity investments	Chapter 11 of the FRF for SMEs requires recurring adjustments of the carrying amount of debt and equity investments that management is currently attempting to sell for changes in their market value. Those changes in market value during each period are recognized in net income. If the securities are not held for sale, they are recorded at historical cost.	GAAP requires recurring adjustments of the carrying amount of marketable debt and equity securities for changes in their fair value. Changes in fair value for marketable securities classified as available for sale are reported in other comprehensive income rather than net income.

OBSERVATION: Although one of the items listed above says the entity is a for-profit entity, we believe there may be some nonprofit organizations that could use the Framework. For example, nonprofits that are not impacted by specialized accounting guidance on contributions and net asset classifications may find this to be an appropriate framework. That could include organizations such as country clubs or trade associations.

KEY DIFFERENCES BETWEEN THE FRAMEWORK AND GAAP*

Much of the guidance in the FRF for SMEs is very similar to the requirements contained in GAAP. For example, both GAAP and the new Framework state that financial statements normally include a statement of financial position, a statement of operations, a statement of changes in equity, and a statement of cash flows, although the titles of the statements may be slightly different. It is acceptable to present an individual financial statement, but if a statement of financial position and statement of operations are presented, then a statement of cash flows must also be presented. However, a difference is that GAAP also includes a statement of comprehensive income, when applicable, and the new Framework does not include the concept of comprehensive income.

OBSERVATION: The Framework notes that judgment is required when selecting the specific financial statement titles and further explains that GAAP titles, such as statement of financial position and statement of operations, are not the only acceptable titles. The guidance in AU-C 800.15 and .A17 indicates that titles of OCBOA financial statements should differ from those for similar statements prepared in accordance with GAAP so that there is no implication that the statements are presented in conformity with GAAP. Accordingly, we believe that financial statements prepared under the new Framework should not use GAAP titles to avoid confusing users of the financial statements about the basis on which they are prepared.

*Refer to the table above and on the previous page to see the differences between GAAP and the FRF for SMEs that we consider to be most significant.

OBSERVATION: Only one or two of the differences noted in the table may provide the necessary incentive for an entity to choose to adopt the FRF for SMEs rather than GAAP. For example, many executives and financial statement users (and possibly some practitioners) struggle to understand and apply the GAAP guidance related to other comprehensive income and deferred income taxes. One practitioner stated that "providing a simpler alternative than reporting changes in the fair value of held-for-sale marketable securities in other comprehensive income would be enough incentive for an entity to convert from GAAP to the FRF for SMEs." As a result, the less complex options in the FRF for SMEs for some accounting areas may compel small- and medium-sized entities to adopt this new reporting framework. The reasons for changing frameworks may vary among entities depending on their businesses and financial statement users.

CHANGES IN GAAP SINCE THE FRAMEWORK WAS ISSUED

First, it is important to understand that the FRF for SMEs is another alternative when GAAP is not required, but it is not GAAP and it does not modify existing GAAP. The FASB is the only entity that can issue or modify GAAP.

The FASB, through input from the PCC, has made several recent changes to GAAP to provide exceptions or modifications to existing GAAP to address the needs of private company financial statement users. Those changes include the following new Accounting Standard Updates (ASUs):

- ASU 2014-02, *Accounting for Goodwill*, provides an accounting alternative for goodwill by allowing nonpublic entities to elect to amortize goodwill using straight-line amortization over 10 years (or less than 10 years if the entity determines that a shorter period is more appropriate). That accounting alternative, if elected, should be applied prospectively to goodwill existing as of the beginning of the period of adoption and new goodwill recognized in annual periods beginning after December 15, 2014. However, early application is permitted, including application to any period for which the entity's annual or interim financial statements have not yet been made available for issuance.

- ASU 2014-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach*, provides a simplified hedge accounting approach for private companies that enter into certain plain vanilla interest rate swaps solely to convert variable-rate debt to a fixed rate. The ASU allows those swaps to be measured at settlement value rather than fair value, and the hedge documentation can be completed up to the date that the first annual financial statements are available to be issued. While the swap still has to be recognized in the financial statements, determining the settlement value of the swap should be easier than determining its fair value. The ASU is effective for annual periods beginning after December 15, 2014, with early adoption permitted.

- ASU 2014-07, *Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*, provides an option for a private company lessee to elect to not apply the VIE guidance in GAAP to a lessor entity if certain criteria are met. In that case, the reporting entity would not have to consolidate the lessor entity. That alternative is effective for annual periods beginning after December 15, 2014, with early adoption permitted.

Each of those new ASUs has addressed an accounting and financial reporting topic within GAAP that had often frustrated small- and medium-sized private entities. In addition, the PCC is currently working on another project that would simplify the accounting for identifiable intangible assets acquired in a business combination. Finally, the PCC is reaching out to its constituents and asking them to identify other areas that the PCC should address.

OBSERVATION: As further modifications are made to existing GAAP to address the needs and frustrations of many private companies, the need for and benefits of converting to the Framework may be lessened.

NEXT STEPS

Small- and medium-sized entities can choose to adopt the Framework at any time. Here are some questions to consider when deciding whether the Framework is appropriate for use in specific situations:

- Is the entity owner managed so that those who own a controlling interest in the entity are also the managers who run the entity and are more familiar with its operating issues?
- Do loan covenants or other agreements currently allow for financial statements prepared on a basis of accounting other than GAAP or can they be amended to allow that alternative?
- Would the additional cost of compliance with GAAP be significant?
- Are the financial statements currently prepared on an OCBOA (such as the tax basis) and would the Framework better meet the needs of the users?
- Do the external users have direct access to management?
- Does the entity operate in an industry without significant specialized accounting requirements?

If you conclude that use of the Framework is appropriate, ensure that the financial statements are clearly distinguishable from GAAP financial statements, and significant differences from GAAP are disclosed. To reiterate:

- We believe that financial statements prepared under the Framework should not use GAAP titles to avoid confusing users of the financial statements about the basis on which they are prepared.
- The Framework requires the notes to the financial statements to prominently state the basis of accounting used to prepare the financial statements. In addition, as required by the compilation, review, and auditing literature, practitioners who are reporting on financial statements prepared under the Framework should ensure that those statements adequately disclose the differences from GAAP.

AVAILABLE RESOURCES

The Tax & Accounting business of Thomson Reuters has recently released a new product titled *PPC's Guide to the Financial Reporting Framework for Small- and Medium-Sized Entities*. That *Guide* provides you the information you need to consider before discussing the new Framework with clients, potential clients, and financial statement users. It provides details of differences between GAAP and the Framework, including both accounting and disclosures; illustrates and explains the conversion of two entities' GAAP-basis financial statements to the FRF for SMEs; presents sample reports for an audit, review, and compilation engagement; provides a disclosure checklist tailored for the Framework so you can ensure all appropriate disclosures are included in the financial statements; and includes a PowerPoint presentation to use with clients and third-party users to explain the Framework. The Framework is also available on Checkpoint and customers that purchase both can utilize the links between the Guide and the Framework for further research.

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