

# Heads Up

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## No Small Matter?

# AICPA Proposes Financial Reporting Framework for Small and Medium-Sized Entities

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On November 1, 2012, the AICPA issued an [exposure draft](#) (ED)<sup>1</sup> requesting feedback on its proposed special-purpose financial reporting framework<sup>2</sup> for small and medium-sized entities (the *FRF for SMEs*), which is intended for use by SMEs that are not required to prepare financial statements in accordance with U.S. GAAP. This *Heads Up* gives an overview of the *FRF for SMEs* and outlines factors entities may consider when adopting the proposed framework.

## Background, Purpose, and Scope

In January 2011, the Blue-Ribbon Panel (BRP) on Standard Setting for Private Companies issued a [report](#) that, among other things, highlighted systemic issues with the current U.S. accounting standard-setting process, notably the failure to sufficiently (1) understand the needs of users of private-company financial statements and (2) weigh the cost-benefit considerations related to U.S. GAAP for use in private-company reporting. In response, the Financial Accounting Foundation (FAF) created the Private Company Council (PCC) in May 2012, which is charged with (1) determining whether exceptions or modifications to existing U.S. GAAP would be warranted for private companies and (2) advising the FASB on private-company accounting matters during the standard-setting process. The PCC's responsibilities:

1. Do not include establishing an alternative FRF for private companies that would be separate from U.S. GAAP.
2. May not be limited to accounting guidance for small and medium-sized private companies, because the PCC is tasked with addressing U.S. GAAP accounting matters related to all entities that meet the definition of nonpublic entity.<sup>3</sup>

The AICPA requests feedback on its proposed special-purpose financial reporting framework for small and medium-sized entities.

<sup>1</sup> AICPA Exposure Draft, *Proposed Financial Reporting Framework for Small- and Medium-Sized Entities*.

<sup>2</sup> Special-purpose financial reporting frameworks are also referred to as other comprehensive bases of accounting and include the cash basis, modified cash basis, tax basis, regulatory basis, and other bases of accounting that are not equivalent to U.S. GAAP housed in the *FASB Accounting Standards Codification*.

<sup>3</sup> In July 2012, the FASB issued an [Invitation to Comment, Private Company Decision-Making Framework — A Framework for Evaluating Financial Accounting and Reporting Guidance for Private Companies](#). This proposal includes the FASB's tentative decisions to date regarding the definition of a private company (also referred to as a nonpublic entity) and asked stakeholders to provide input on this definition by November 9, 2012. See Deloitte's August 7, 2012, [Heads Up](#) for more information.

The *FRF for SMEs* is intended to be a comprehensive framework for SMEs that are not required to prepare financial statements in accordance with U.S. GAAP.

However, in a November 1, 2012, [press release](#), AICPA CEO Barry C. Melancon notes that “[s]takeholders involved with private small- and medium-sized business entities’ financial reporting have made it known that they are looking for an alternative to the current financial reporting systems outside of GAAP.” In response, the AICPA developed its proposed *FRF for SMEs*, stating that it is intended to be “less complicated and less costly” than U.S. GAAP and that it will provide a solution for those “who need financial statements that are prepared in a consistent and reliable manner in accordance with a framework that has undergone public comment and professional scrutiny.” Thus, the *FRF for SMEs* is intended to be a comprehensive framework for SMEs that are not required to prepare financial statements in accordance with U.S. GAAP. An entity’s management would decide whether to use the *FRF for SMEs*.

**Editor’s Note:** Factors management may consider when deciding whether to use the *FRF for SMEs* include (1) the definition of SME and (2) whether the entity intends to issue debt or equity securities to the public.

Regarding the definition of SME, the AICPA notes in its [frequently asked questions](#) that “[t]here is no standard definition of SME in the United States and the AICPA does not define the term either.” Because the AICPA does not have the authority to require or enforce the use of the *FRF for SMEs*, any entity that is not required to prepare financial statements in accordance with U.S. GAAP or a comprehensive basis of accounting other than the *FRF for SMEs* may choose to use the *FRF for SMEs*, including entities that may not be considered small or medium-sized.

Regarding management’s intention to go public, the ED’s foreword states that “[o]wners and management that do have such an intention should consider using GAAP in the preparation of their financial statements.”

## Overview of Proposed Framework

The *FRF for SMEs* provides guidance on accounting for certain transactions and preparing financial statements. Although the accounting for certain transactions under the *FRF for SMEs* is similar to that under U.S. GAAP, the *FRF for SMEs* requires entities to measure assets and liabilities at fair value in far fewer instances than U.S. GAAP. Other notable differences between the *FRF for SMEs* and U.S. GAAP include, but are not limited to, the following:

- The *FRF for SMEs* does not contain a separate category of income for other comprehensive income or extraordinary items.
- Under the *FRF for SMEs*, an entity can elect, as its accounting policy, to use proportional consolidation, the consolidation or equity method, or the cost method to account for investments in joint ventures.
- “Push-down” accounting is permitted under the *FRF for SMEs* when all, or virtually all, of the equity interests in an entity are acquired, in one or more transactions between unrelated parties, by an acquirer that controls the acquiree. However, the *FRF for SMEs* does not require “push-down” accounting. The comparable guidance under U.S. GAAP, which is based on SAB Topic 5.J,<sup>4</sup> can be complex and is only required for public companies.
- Under the *FRF for SMEs*, goodwill and other intangible assets are amortized; under U.S. GAAP, amortization of goodwill and other indefinite-lived intangible assets is prohibited.
- The *FRF for SMEs* requires entities to measure inventories at the lower of cost or market. Market is defined as net realizable value (NRV), which is equal to the “estimated selling price in the ordinary course of business less the estimated cost of completion and the estimated costs necessary to make a sale.” Under U.S. GAAP, this requirement is similar but market is defined as current replacement cost provided that it does not exceed NRV and is not less than NRV reduced by a normal profit margin.

<sup>4</sup> SEC Staff Accounting Bulletin Topic 5.J, “New Basis of Accounting Required in Certain Circumstances.”

Because the *FRF for SMEs* is principles-based and lacks much of the guidance found in U.S. GAAP, management may need to use judgment to determine its accounting policies, particularly on topics that are not directly addressed by the *FRF for SMEs*.

- Losses recognized under the *FRF for SMEs* may be reversed for (1) a write-down of inventory to market if it is lower than cost, (2) the impairment of long-lived assets, and (3) the impairment of equity investments. Entities are prohibited from reversing such losses under U.S. GAAP.
- Under the *FRF for SMEs*, investments in equity securities are accounted for under the cost method or the equity method if the investor holds significant influence. However, the *FRF for SMEs* does not permit entities to account for such investments at fair value with changes recognized in other comprehensive income. In addition, the *FRF for SMEs* only permits entities to account for equity investments at fair value with changes through net income if the investment is held for sale.

## Adoption

When adopting the *FRF for SMEs*, management will generally establish accounting policies governing the accounting and reporting of business transactions and related financial information. Paragraph 2.15 of the ED states that “[m]anagement should select one set of accounting policies for purposes of preparing general purpose financial statements in accordance with the *FRF for SMEs*.” Under the *FRF for SMEs*, an entity would disclose its significant accounting policies in the notes to the financial statements. Because the *FRF for SMEs* is principles-based and lacks much of the guidance found in U.S. GAAP, management may need to use judgment to determine its accounting policies, particularly on topics that are not directly addressed by the *FRF for SMEs*.

Topics that are not covered in the *FRF for SMEs* may be addressed in future updates proposed by the AICPA’s *FRF for SMEs* task force. The ED’s foreword states that “[t]he task force intends to review and propose amendments to the *FRF for SMEs* approximately every three or four years. Amendments will be primarily based on input from stakeholders and developments in accounting and financial reporting.” These amendments will generally be available for adoption as soon as they are issued.

**Editor’s Note:** Management may use existing reporting frameworks, such as U.S. GAAP or IFRSs (as issued by the IASB), as the basis for its accounting policies related to transactions that are not addressed in the *FRF for SMEs*. Alternatively, management could choose an accounting alternative that is not contemplated in an existing framework. This may result in diversity in practice and decrease the comparability of financial statements prepared in accordance with the *FRF for SMEs*, even those prepared by entities within the same industry.

## Next Steps

Comments on the ED are due by January 30, 2013, and the AICPA plans to finalize the *FRF for SMEs* in the first half of 2013. Because the *FRF for SMEs* does not have an effective date, entities can apply it as soon as it is finalized. The AICPA will incorporate into the final framework a separate companion volume that includes examples, illustrative financial statements, and implementation guidance on such topics as defined benefit pension plans.

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