

AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities: Frequently Asked Questions



1. What is the Financial Reporting Framework for Small- and Medium-Sized Entities?

All financial statements are prepared in accordance with a financial reporting framework. The term *financial reporting framework* is defined as a set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements. Examples of financial reporting frameworks are generally accepted accounting principles (GAAP) in the United States of America, International Financial Reporting Standards (IFRSs), and special purpose frameworks (also known as other comprehensive bases of accounting [OCBOA]).

The Financial Reporting Framework for Small- and Medium-sized Entities (FRF for SMEs) is a self-contained special purpose framework intended for use by privately held small-to-medium-sized entities (SMEs) in preparing their financial statements. The FRF for SMEs draws upon a blend of traditional methods of accounting with some accrual income tax methods. The framework is being developed by a working group of CPA professionals and AICPA staff who have years of experience serving smaller-to-medium-sized private entities. The FRF for SMEs has been exposed for public comment to solicit broad stakeholder input. The AICPA expects to issue the final framework in the first half of 2013.

2. What is a SME?

SMEs pervade the business world in virtually every jurisdiction, from the largest economies to the smallest. In terms of sheer numbers the segment is sizeable. Estimates put the number of SMEs in the United States at approximately 20 million.¹ They are active in every industry group and involved in providing goods and services in a wide-ranging set of activities. There is no standard definition of a SME in the United States and the AICPA does not define the term either.

3. Why would SMEs use the FRF for SMEs?

The FRF for SMEs will be a less complicated and less costly system of accounting for SMEs that are not required to produce U.S. GAAP-based financial statements. The FRF for SMEs will be a cost-beneficial solution for owner-managers and others 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. The accounting principles composing the FRF for SMEs are intended to be the most appropriate for the preparation of SME financial statements based on the needs of the financial statement users and cost-benefit considerations. Accounting principles in the FRF for SMEs will be responsive to the well-documented issues and concerns stakeholders currently encounter when preparing financial statements for SMEs.

4. What type of entities is the FRF for SMEs intended for?

The FRF for SMEs is being developed for smaller- to medium-sized, owner-managed, for-profit entities that need reliable financial statements where internal or external users have direct access to the owner-manager and GAAP financial statements are not required. The FRF for SMEs may be used by entities in most industry groups and by unincorporated and incorporated entities.

¹ "IFRS for SMEs in Your Pocket," Deloitte, April 2010.

It would be an impossible task to define conclusively the characteristics of a typical entity that would use and benefit from the FRF for SMEs. The FRF for SMEs is intended for owner-managers who rely on a set of financial statements to confirm their assessments of performance, and of what they own and what they owe, and to understand their cash flows. Often, their 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 related to the financial statements. A majority of these owner-managers have no expectations of going public.

The AICPA has no authority to require the use of the FRF for SMEs for any entity. Therefore, the FRF for SMEs will have no effective date and an owner-manager can decide to use the FRF for SMEs once it is released. An owner-manager should make that decision in conjunction with those who may use the entity's financial statements.

5. What is meant by *owner-managed* entity? Is the FRF for SMEs only intended for owner-managed entities?

Owner-managed entities are closely held companies where the people who own a controlling ownership interest in the entity are substantially the same set of people who run the company—in contrast with public companies where the ownership and management are clearly separated. Owner-managed businesses represent the majority of all businesses in the United States. Often, owner-managed entities do not have a qualified CPA on staff. Rather, the owner-managers or bookkeepers maintain the entities' books and records.

The term *owner-managed* was selected to help describe the typical entity that would benefit from using the FRF for SMEs. The AICPA does not intend to scope out entities that may not be owner managed from using the FRF for SMEs. Entities that have operational management who are not the owners may find that the FRF for SMEs is an ideal choice for their financial reporting needs and circumstances.

6. Are there any entities prohibited from using the FRF for SMEs?

The AICPA cannot preclude an entity from preparing its financial statements under the FRF for SMEs. The FRF for SMEs is intended to be used by small- and medium-sized for-profit entities. Typically, the FRF for SMEs would be used by owner-managers who rely on a set of financial statements to confirm their assessments of performance, and of what they own and what they owe and the entity's cash flows.

7. What is a special purpose framework?

Special purpose frameworks include cash basis, modified cash basis, tax basis, regulatory basis, contractual basis, and other bases of accounting that utilize a definite set of logical, reasonable criteria that is applied to all material items appearing in the financial statements. Special purpose frameworks, with the exception of the contractual basis of accounting, are commonly referred to as OCBOA.

By far, the tax and modified cash bases are the most frequently used special purpose frameworks today. Historically, there have been no definitive requirements for special purpose framework financial statements. Nonauthoritative guidance on special purpose framework financial statements can be found in the AICPA's Technical Questions and Answers, which are available in *Technical Practice Aids*.

8. How does the FRF for SMEs differ from other special purpose frameworks like the tax and cash bases of accounting?

Unlike the tax or cash bases of accounting, the FRF for SMEs will undergo public exposure and professional scrutiny and contain explicit and comprehensive accounting principles. These features result in a reliable and consistently applied financial framework.

9. Is the FRF for SMEs authoritative?

No. The FRF for SMEs is a type of special purpose framework that is being developed by the AICPA's FRF for SMEs task force and AICPA staff and will be exposed to public comment and professional scrutiny. The FRF for SMEs will not be approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA or the Financial Accounting Standards Board and will have no official or authoritative status.

10. Can a non-CPA prepare financial statements using the FRF for SMEs?

Yes. Non-CPAs may prepare financial statements using available financial frameworks including the FRF for SMEs, cash, tax, and even GAAP bases of accounting.

11. How do CPAs report on financial statements prepared under the FRF for SMEs?

CPA practitioners performing audit, review, or compilation engagements on financial statements prepared under the FRF for SMEs will follow the same standards as they do today when reporting on other special purpose framework financial statements. The AICPA will be providing audit, review, and compilation report examples to assist CPAs in reporting on financial statements prepared under the FRF for SMEs.

12. Is there industry-specific guidance in the FRF for SMEs?

The FRF for SMEs is a principles-based framework that can be used by incorporated and unincorporated entities across industries. Specific industry-specific guidance will therefore not be included in the FRF for SMEs.

13. How will the FRF for SMEs be maintained in the future?

A key feature of the FRF for SMEs is that it will be a stable framework that will not undergo frequent changes. Notwithstanding, the FRF for SMEs will be nimble and responsive to significant developments in financial reporting.

14. How is the FRF for SMEs less complicated and less costly?

The FRF for SMEs will be constructed of accounting principles that are especially suited and relevant to a typical SME. Examples include the following:

- The FRF for SMEs will use historical cost as its measurement basis and depart from the increased use of fair value.
- The FRF for SMEs will not require complicated accounting for derivatives, hedging activities, or stock compensation.

Moreover, the FRF for SMEs disclosure requirements will be greatly reduced, providing users of financial statements with the relevant information they need while recognizing that those users can obtain additional information from management if they desire.

15. How is the FRF for SMEs more relevant for SMEs?

The FRF for SMEs is designed specifically to suit the needs of small- and medium-size entities and their stakeholders. Familiar traditional accounting and accrual income tax accounting principles will comprise the FRF for SMEs and only financial reporting topics that are pertinent and have meaning to most SMEs and their financial statement users will be included. For example, there will be no concept of comprehensive income in the FRF for SMEs. The FRF for SMEs assists owner-managers and other SME stakeholders in focusing on the performance of the SME, its assets, liabilities, and cash flows.

16. AU-C Section 800 (AU Section 623) states that if special purpose framework financial statements include items that are the same or similar to those in GAAP financial statements, similar informative disclosures are appropriate. Because the FRF for SMEs is a special purpose framework in accordance with AU-C Section 800, will those “similar informative disclosure” requirements apply?

Yes, the provisions of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), will apply to financial statements prepared under the FRF for SMEs. The AICPA task force and staff developing the framework believe that the disclosure requirements contained in the FRF for SMEs will meet the “similar informative disclosures” requirement of AU-C section 800.

17. Will lenders/financial institutions accept financial statements prepared under the FRF for SMEs?

Owner-managers and their CPA practitioners will need to consult with lenders and other key external stakeholders about the use of the FRF for SMEs. With substantial relevance and cost-benefit factors, the AICPA believes that the lending community will accept financial statements prepared under the FRF for SMEs. Lenders are often very flexible in accommodating various financial frameworks for smaller entities. For example, many lenders today permit financial statements prepared using the cash or income tax basis of accounting from their customers. More important to lenders is the consistent application of the accounting principles underlying the financial statements. The FRF for SMEs will consist of traditional accounting principles and accrual income tax accounting methods that are very familiar to lenders and have served the lending community well for many years.

The FRF for SMEs is intended to be utilized by entities whose lenders base their decisions principally on reliable operations and cash flows. The FRF for SMEs will appeal to such lenders because it will be a reliable financial framework, providing relevant information, will be easier to understand, will contain explicit and comprehensive accounting principles, and will be subjected to professional scrutiny. Moreover, the FRF for SMEs will be a cost-beneficial financial reporting option for the lenders’ customers.

18. How does the FRF for SMEs fit in with the Financial Accounting Foundation's Private Company Council and standard setting in the United States?

The AICPA and the Financial Accounting Foundation (FAF) are both committed to the private company financial reporting constituency; however, the objectives of these two efforts are different. The new FAF Private Company Council will focus on modifications to U.S. GAAP for private companies that need or are required to have financial statements prepared in accordance with GAAP. The FRF for SMEs is a concise, highly relevant framework for owner-managers of SMEs and their external stakeholders where U.S. GAAP financial statements are not required or necessary.

19. Why do we need the FRF for SMEs now that the new Private Company Council has been established?

For decades the AICPA has wanted private companies and their financial statement users to have the information that suits their unique needs and is cost beneficial to them. The new Private Company Council and the FASB will be working toward that goal and the AICPA is committed to the new council's success. But that solution only helps private companies that need U.S. GAAP financial statements. The fact is, many SMEs do not need GAAP financial statements and their financial reporting needs can be better addressed by a less complicated and more relevant financial framework like the FRF for SMEs.

20. Why not promote the use of IFRS for SMEs rather than develop a new framework?

The International Accounting Standards Board has been recognized by the AICPA as an international accounting standard setting body and, as a result, the IFRS for SMEs may be an alternative for those SMEs needing GAAP financial statements. Although there will be some similarities between the FRF for SMEs and the IFRS for SMEs, the AICPA believes that the FRF for SMEs will be more understandable and more useful at this time because it is specifically written for U.S. entities. Additionally, the FRF for SMEs will reduce differences between the FRF for SMEs and the U.S. tax code. For example, last in, first out inventory is not permitted by the IFRS for SMEs whereas it will be permitted by the FRF for SMEs.

21. Is developing the FRF for SMEs a way for the AICPA to become an accounting standard setter?

No. The FRF for SMEs is a nonauthoritative financial reporting framework that can be used voluntarily by entities that do not need GAAP financial statements. The AICPA has no authority to compel or preclude the use of the FRF for SMEs. The FAF supports the AICPA's development of the FRF for SMEs, calling it "important and complementary."

22. Is the FRF for SMEs inferior or superior to GAAP?

The FRF for SMEs is neither inferior nor superior to GAAP. The issue is about what is the most suitable financial reporting framework for an entity. Many SMEs do not need GAAP financial statements and the FRF for SMEs may be the right choice to satisfy their financial reporting needs and those of their stakeholders.

23. What is the long-term future of the FRF for SMEs in light of the growing convergence of U.S. financial reporting standards with IFRS and global accounting trends?

The AICPA expects that the FRF for SMEs will be a very useful financial reporting system in the United States as owner-managers of SMEs, their accountants, and their external stakeholders recognize its benefits. The FRF for SMEs is a financial reporting framework for those entities that do not need GAAP. As such, the convergence of U.S. GAAP with IFRS does not directly impact the FRF for SMEs. As the U.S. financial reporting environment continues to evolve in response to global forces, such as convergence and adoption of IFRS and the emergence of the IFRS for SMEs, the FRF for SMEs will remain a relevant framework and key element in that evolving environment.

24. What are the implications for peer reviewers related to the FRF for SMEs?

The responsibilities related to a peer review will be no different from what they are today when a peer review is conducted of an audit, review, or compilation of financial statements prepared in accordance with a special purpose framework. A peer reviewer will need to be familiar with the performance and reporting standards of the Statements on Auditing Standards or the Statements on Standards for Accounting and Review Services, as well as the FRF for SMEs. The peer reviewer must apply professional judgment to determine if the recognition, measurement, presentation, and disclosure principles followed are appropriate in determining whether the CPA's report is correct.

25. Will the Uniform CPA Examination include questions pertaining to the FRF for SMEs?

Those responsible for the preparation of the CPA Exam will monitor usage of the FRF for SMEs, as they would do for other financial reporting frameworks. If FRF for SMEs usage becomes prevalent, questions about the FRF for SMEs could eventually be included in the CPA Exam.

26. Will the AICPA provide implementation guidance and tools to assist financial statement preparers, CPA practitioners, and financial statement users in learning about and applying the FRF for SMEs?

Yes. Implementation guidance, in the form of application examples, illustrative financial statements, a disclosure checklist, and similar tools will be offered by the AICPA to complement the FRF for SMEs. In addition, toolkits will be available to help CPA firms introduce and explain the FRF for SMEs and its advantages to clients and financial statement users.

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