AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

# BDO **FLASH** REPORT
# FASB

## SUBJECT

# ADVANCES IN PRIVATE COMPANY ACCOUNTING

## SUMMARY

On June 11, 2013, the American Institute of Certified Public Accountants (AICPA) released its 206-page Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs OR the framework), which is a *new* accounting framework option designed to help small businesses prepare streamlined, relevant financial reports. This special purpose framework is an "other comprehensive basis of accounting" (OCBOA) and is intended for smaller- to medium-sized for-profit private companies that do *not* need U.S. generally accepted accounting principles (GAAP) financial statements. *However, the framework is neither authoritative nor is its use required.* The framework is available for immediate use by incorporated or unincorporated entities across various industries. Specific industry guidance is not included in the framework. The framework is not intended as a substitute for GAAP when GAAP-based financial statements are necessary, as determined by the management of a private company and its financial statement users.

On the same day, the Financial Accounting Standards Board (FASB) endorsed three proposals from the Financial Accounting Foundation's (FAF) Private Company Council (PCC) to simplify accounting for private companies in the areas of intangible assets acquired in business combinations, goodwill and certain types of interest rate swaps. Exposure drafts on these three proposals are expected to be issued by the FASB in late June.

The objectives of the AICPA and FAF's PCC are different: the PCC focuses on modifications to U.S. GAAP for private companies that need or are required to prepare financial statements in accordance with GAAP, while the AICPA has prepared the FRF for SMEs framework for companies that do not require GAAP financial statements.

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## OVERVIEW OF THE AICPA FRF FOR SMEs

The FRF for SMEs is a special purpose framework[1]. The framework draws upon a blend of traditional accounting principles (e.g., matching of revenues and expenses) and accrual methods of accounting. It utilizes historical cost as its primary measurement basis and moves away from fair value and focuses on cash flows. The AICPA describes the framework as providing users with a "suitable degree of optionality when choosing accounting principles to better meet the needs of end users of the financial statements." The framework "eschews prescriptive, detailed standards and voluminous disclosure requirements." Thus, it requires the use of professional judgment.

The framework was developed by a working group of CPA professionals and AICPA staff experienced in serving small businesses. It is intended as a cost-beneficial solution for owners and managers to reduce complexity and cost. The framework will be reviewed and amended every three to four years based on input from stakeholders and developments in accounting and financial reporting.

**Accessing the Framework and Other Resources**
Click here for access to a free copy of the framework.

In late June, the AICPA will be providing an informational framework toolkit. In the meantime, for more information on the framework, including a Frequently Asked Questions and Answers document, click here.

## OVERVIEW OF FAF PCC PROPOSALS

On the same day the AICPA released its framework, the FASB had endorsed three accounting alternatives to U.S. GAAP proposed by the PCC to address concerns raised about the relevance and complexity of certain aspects of U.S. GAAP for private company stakeholders.

The PCC was established to work jointly with the FASB to agree on criteria to decide whether and when exceptions or modifications to U.S. GAAP are warranted for private companies as well as to advise the FASB on appropriate treatment for private companies for items under active consideration on the FABS's technical agenda. The FASB will need to endorse any modifications and exceptions that result from the PCC's and FASB's collaboration.

### What are SMEs?

While there is no standard definition of SME in the United States, characteristics of typical companies that may utilize the framework are presented in the preface to the FRF for SMEs framework. These include, but are not limited to:

- 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.

[1] Special purpose frameworks (with the exception of the contractual basis of accounting) are commonly referred to as *other comprehensive bases of accounting* or OCBOA. Special purpose frameworks include cash basis, modified cash basis, tax basis, regulatory basis, contractual basis, and other non-GAAP bases of accounting that utilize a definite set of logical, reasonable criteria that is applied to all material items appearing the financial statements.

The FASB expects to issue the three initial proposals as Exposure Drafts for public comment in late June. The proposals involve alternative accounting for intangible assets acquired in business combinations, goodwill and certain types of interest rate swaps as follows:

- Proposal 1: PCC Issue No. 13-01, *Accounting for Identifiable Intangible Assets in a Business Combination*, would not require private companies to separately recognize certain intangible assets acquired in a business combination. The proposal would enable private companies that elect the alternative within U.S. GAAP to recognize only those intangible assets arising from noncancelable contractual terms or those arising from other legal rights. Otherwise, an intangible asset would not be recognized separately from goodwill even if it is separable.

- Proposal 2: PCC Issue No. 13-01B, *Accounting for Goodwill Subsequent to a Business Combination*, would allow for amortization of goodwill and a simplified goodwill impairment model. This would enable private companies that elect the alternative within U.S. GAAP to amortize goodwill over the useful life of the primary asset acquired in a business combination, not to exceed 10 years. Goodwill would be tested for impairment only when a triggering event occurs that would more likely than not reduce the fair value of a company below its carrying amount. Goodwill would be tested for impairment at the companywide level as compared to the current requirement to test at the reporting unit level.

- Proposal 3: PCC Issue No. 13-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps*, would allow private companies the option to use two simpler approaches to account for certain types of interest rate swaps that are entered into by a private company for the purposes of economically converting its variable-rate borrowing to a fixed-rate borrowing. Under both approaches, the periodic income statement charge for interest would be similar to the amount that would result if the private company were to have entered into fixed-rate borrowing instead of variable-rate borrowing. The two approaches would apply to all private companies, except for financial institutions.

For further information on these and other PCC agenda issues, click here. You may also refer to BDO's quarterly Significant Accounting & Reporting Matters publications for updates on developments available at: http://www.bdo.com/publications/assurance/.

## Private Company Comparison of the AICPA FRF to the PCC Accounting Proposals

| | Financial Reporting Framework for SMEs | FAF Private Company Council Accounting Proposals |
|---|---|---|
| **Objective** | Intended for smaller to medium-sized for-profit private companies that do *not* require generally accepted accounting principles (GAAP) financial statements to assist them in preparing streamlined and relevant financial reports | Intended to improve the process of setting accounting standards for private companies and determine whether exceptions or modifications to existing nongovernmental U.S. GAAP are necessary to address the needs of users of private company financial statements |
| **Identifiable Intangible Assets in a Business Combination** | • Would still require private companies to separately recognize identifiable intangible assets acquired in a business combination if they are reliably measurable (FRF 28.09-28.11). However, an entity may make an accounting policy choice not to separately recognize the intangible asset as an identifiable asset and subsume into goodwill the value of the intangible asset (FRF 28.18 - .19) | • Would not require private companies to separately recognize certain intangible assets acquired in a business combination<br>• Permits recognition of only those intangible assets arising from noncancelable contractual terms or those arising from other legal rights. Otherwise, an intangible asset would not be recognized separately from goodwill even if it is separable<br>(PCC Issue No. 13-01) |
| **Goodwill Subsequent to a Business Combination** | • Allows for amortization of goodwill over the same period as that used for federal income tax purposes or, if not amortized for federal income tax purposes, then a period of 15 years (FRF 13.60)<br>• Does not require impairment testing of goodwill | • Allows for amortization of goodwill and a simplified goodwill impairment model<br>• Permits amortization of goodwill over the useful life of the primary asset acquired in a business combination, not to exceed 10 years<br>• Would require impairment testing only when a triggering event occurs that would more likely than not reduce the fair value of a company below its carrying amount and would be at the companywide level (i.e., not at the reporting unit level)<br>(PCC Issue No. 13-01B) |
| **Certain Receive-Variable, Pay-Fixed Interest Rate Swaps** | • Does not require derivative accounting and financial reporting or fair value accounting for interest rate swaps<br>• Requires adequate disclosures about the swap to enable lenders and other financial statement users to understand the nature and terms of the swap (FRF 6.21) | • Allows the option to use two simpler approaches to account for certain types of interest rate swaps that are entered into by a private company for the purpose of economically converting its variable-rate borrowing to a fixed-rate borrowing<br>• Under both approaches, the periodic income statement charge for interest would be similar to the amount resulting from fixed-rate borrowing instead of variable-rate borrowing<br>• Applies to all private companies, except for financial institutions<br>(PCC Issue No. 13-03) |

## Other Accounting Simplifications Included Within the AICPA FRF

The following is not a complete list but rather focuses on some of the more common areas for consideration.

| | Financial Reporting Framework for SMEs |
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| **Lease Accounting** | • Retains traditional lease accounting approach that is closely aligned with how leases are treated for income tax purposes: operating and capital leases<br>• Requires adequate disclosures |
| **VIE Consolidation** | • Does not include the concept of variable-interest entities (VIEs) |
| **Other Comprehensive Income** | • Does not include the concept of other comprehensive income (OCI) |
| **Income Taxes Payable** | • Allows companies to follow the income taxes payable method when accounting for income taxes |

# ADDITIONAL CONSIDERATIONS FOR MANAGEMENT AND THOSE CHARGED WITH GOVERNANCE

Note: The following are questions for consideration by potential users of the framework for private company non-GAAP financial statements as well as for those considering applying the alternatives being outlined in forthcoming proposals by the FASB to private company financial statements prepared under U.S. GAAP, including management and those charged with governance of private companies. The questions have been prepared based upon certain of the AICPA's framework *Frequently Asked Questions*, information provided by the FAF PCC, as well as BDO's own insight.

### *Is the FRF for SMEs framework authoritative? Who is required to use it?*

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

Its use is not required but rather optional. Companies choosing to or required to provide GAAP financial statements should not use the FRF for SMEs framework. Management and those charged with governance should carefully consider which financial reporting methodology – GAAP or non-GAAP – is most appropriate, given their particular business circumstances, including lending, insurance and regulatory requirements.

Examples of companies that may find the FRF beneficial are included above under the characteristics of SMEs.

### *Will the PCC proposals issued by FASB in the form of Exposure Drafts become "GAAP?" What are the expected effective dates of such proposals?*

Yes, once approved by the FASB, proposed accounting options for private companies included within the FASB's exposure drafts will become part of the FASB's codification of accounting standards. Effective dates for such proposals are unclear at this point in the process.

### *How are the FRF for SMEs framework and the PCC proposals intended to reduce complexity and cost?*

The AICPA designed the FRF for SMEs framework to be constructed of accounting principles especially suited and relevant to a typical SME. Examples include the following:

- The FRF for SMEs framework uses historical cost as its measurement basis and steers away from more complicated fair value measurements.
- The framework does not require complicated accounting for derivatives, hedging activities, goodwill or stock compensation.
- The FRF for SMEs framework disclosure requirements are targeted, 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.

The PCC is charged with reviewing existing accounting practices and current standard-setting projects with the intention to propose modifications and/or exceptions for private companies to simplify accounting, thereby reducing cost and complexity for private companies and make information more useful to users of private company financial statements.

### *Will lenders and financial institutions accept financial statements prepared under the FRF for SMEs framework?*

Owner-managers will need to consult with lenders and other key external stakeholders about the use of the FRF for SMEs framework. With substantial relevance and cost-benefit factors, the AICPA believes that the lending community will accept financial statements prepared under the FRF for SMEs framework. Lenders are often very flexible in accommodating various financial frameworks for smaller companies. For example, many lenders today permit their customers to supply financial statements prepared using the cash or income tax basis of accounting. More important to lenders is the consistent application of the accounting principles underlying the financial statements. The FRF for SMEs framework consists of traditional accounting principles and accrual income tax accounting methods which are very familiar to lenders and have served the lending community well for many years. The FRF for SMEs framework is intended to be utilized by companies whose lenders base their decisions principally on reliable operations and cash flows. The framework will appeal to such lenders because it is a reliable financial framework, providing relevant information, is simplified, contains explicit and comprehensive accounting principles, and has been subjected to professional scrutiny. Moreover, the FRF for SMEs framework may be a cost-beneficial financial reporting option for their customers.

### *What types of disclosures will apply to the FRF for SMEs framework?*

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

### *Other Current Considerations?*

As with the adoption of any Other Comprehensive Basis of Accounting or changes to accounting policies, companies should ensure that they have the proper internal structure to support such changes. This includes consideration of developing knowledgeable staff and preparers of financial statements; building or making changes to ensure appropriate infrastructure: including internal controls, policies and procedures, as well as accounting and reporting systems; as well as communicating and educating users of financial statements as to the differences in reporting in both the financial statements themselves along with related disclosures.

## NEXT STEPS

Companies considering use of the AICPA's FRF for non-GAAP financial reporting purposes will need to familiarize themselves with the framework, the available resources and tools forthcoming from the AICPA, and compare and contrast the costs and benefits to their current financial reporting framework. They will further need to ensure that a change to the FRF as an "other comprehensive basis of accounting" will be viewed favorably and be acceptable to users of their financial statements *prior to* adopting the framework.

For other companies that prepare financial statements in accordance with GAAP that may be considering applying the alternative accounting proposals being developed by the FAF PCC, similar considerations will be necessary with respect to performing a cost/benefit analysis; educating preparers of financial statements; getting a sense from users of the financial statements as to whether the new accounting methods and related disclosures will be useful to them; and ensuring any required changes to accounting and reporting systems, internal controls, policies and procedures are in place *prior to* adopting such proposed changes in accounting.