Know Your U.S. Financial Reporting Options

Among a myriad of complex financial accounting and reporting matters facing financial decision makers, accountants and auditors of small to medium-sized privately held businesses in the United States, there is hope. U.S. generally accepted accounting principles (U.S. GAAP) is not the final word of financial reporting and disclosure.

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Over the last decade, financial statement preparers and users have sought practical solutions to provide high-quality financial reporting results without the complications of U.S. GAAP. Fortunately, alternative frameworks do exist. It's just a matter of performing adequate due diligence to decipher which alternative financial reporting framework works best for you—and your clients.

Options

Let's explore the ins and outs of permissible U.S. alternative financial reporting options:

Modified Cash Basis – A basis of accounting used toward cash receipts and disbursements that is not influenced by the financing of sales or purchases and is limited to reporting entities whose operations are relatively simple and without complexities that require significant modifications (i.e., recording of depreciation on fixed assets).

Tax Basis – A basis of accounting the reporting entity uses to file its tax return for the period covered by the financial statements. Typically, businesses that use this basis of accounting are for-profit organizations (e.g., small closely-held companies) for which conversion to U.S. GAAP would exceed the benefit, partnerships whose agreements require such basis, or not-for-profits seeking relief from U.S. GAAP requirements.

Regulatory Basis – A basis of accounting used by the reporting entity to comply with financial reporting requirements of a regulatory agency to which the reporting entity is subject. This is used by insurance companies, credit unions, construction contractors, certain state and local governments, and some not-for-profits.

Contractual Basis – A basis of accounting used by the reporting entity to comply with an agreement between the entity and one or more third parties. Due to the unique aspects in a contract or agreement, it's typical that interpretation is required with regard to measurement principles for the contractual basis.

Financial Reporting Framework for Small and Medium-Sized Entities (FRF for SMEs) – An optional reporting framework that accounts a reporting entity's transactions according to their

economic substance. The use of the historical cost approach is the primary basis of measurement; however, there are also similarities to the accrual income tax basis. For certain accounting policy elections, the FRF for SMEs allows business owners the flexibility to select the policy that best suits financial statement user needs.

The FRF for SMEs does not define a small or medium-sized entity or set a size threshold to be considered an SME. The framework does provide a list (not all-inclusive) that indicates SME characteristics: (1) entity is not required to prepare U.S. GAAP financial statements; (2) entity has no plans to go public in the foreseeable future; (3) entity is for-profit (however, there may be some not-for-profit organizations that could use this framework that are not affected by specialized guidance on contributions and net asset classifications); (4) owners of the entity are involved in business operations; (5) there is no highly specialized accounting guidance for the industry in which the entity operates; (6) there are no overly complex transactions; (7) there are no significant foreign operations; and (8) financial statement users have direct access to management.

Much of the guidance in FRF for SMEs is similar to U.S. GAAP. There are also significant differences: (1) accounting for income taxes; (2) goodwill amortization; (3) accounting for and reporting of variable interest entities; (4) accounting for leases; (5) asset impairment; and (6) accounting for stock-based compensation.

International Financial Reporting Standards (IFRS) – A single set of accounting standards, developed and maintained by the International Accounting Standards Board (IASB), with the intention of applying on a global, consistent basis for both public interest entities and privately held companies. The American Institute of CPAs Council has charged the IASB with establishing international financial reporting standards that give AICPA members the option of using IFRS or IFRS for SMEs (see below) as a U.S. GAAP alternative.

IFRS for Small and Medium-Sized Entities (IFRS for SMEs) – A self-contained standard designed to meet the needs and capabilities of SMEs. Compared to the full IFRS, this is less complex because (1) topics not relevant to SMEs are omitted; (2) many of the accounting principles are simplified; (3) significantly fewer disclosures are required; and (4) the standard is updated every three years.

Deciding on a Reporting Framework

Selecting a U.S. GAAP alternative can benefit both management and its accountants by providing more timely information at a lower cost, such as dealing with fewer measurement requirements. Remember, however, that the alternative financial reporting framework must be accepted by the respective parties with whom management and the client are conducting business. When advising management or clients about the use of alternative financial reporting frameworks, accountants must have a clear idea about their users' needs. For example, these entities are good candidates for modified cash basis or tax basis financial statements:

- Small, closely held businesses with no third-party debt.
- Entity's creditors.
- Owners and managers who are closely involved with the day-to-day business operations.
- Business owners primarily interested in cash flows and transaction tax implications.

Accountants must carefully consider the issues below before advising management and clients about which framework to use:

- Does the company have inventory? If yes, the cash basis may not work.
- Is the company highly leveraged? If yes, financial institutions may require U.S. GAAP financial statements.
- Are there outside investors? If yes, U.S. GAAP financial statements may provide desired information.
- Does the company's cash flow parallel its income and expenses? If yes, the cash basis may be acceptable.
- Does the company anticipate going public? If yes, the company will need a history of U.S. GAAP financial statements.
- Was the company formed for tax purposes? If yes, the owners are probably interested in the tax effect of transactions. Thus, the tax basis would be acceptable.
- Is the company subject to bonding requirements? If yes, most bonding companies require U.S. GAAP financial statements.

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