

Course: Business Model Innovations

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# Business Model Appraisal Frameworks

# SMEs overview



## Responsive

Addresses well-documented financial reporting issues and concerns among SMEs

## Cost effective

Comprehensive and relevant information

## Tailored

Designed to suit financial reporting needs of SMEs and users of their financial statements

# Who could use it?



For use when GAAP-based financial statements are not needed

- Small and medium-sized entities
- Owner-managed/for-profit
- Can be used by many industries
- Incorporated and unincorporated

# Who is it for?



## Owner-Managers

Depend on reliable financial statements to

- Confirm assessments of performance
- Determine what they owe/own
- Understand cash flows

## Users

External financial statement users who have direct access to management

## Non-issuers

No intent of going public

# Features



- Standalone framework
- Concise, in plain English
- Stable but nimble
- Suitable criteria for general-use financial statements
- Blend of traditional accounting and accrual income tax methods
- Fewer adjustments from book to tax

# Features



## Historical cost

Framework primarily uses historical cost basis, steering away from complicated fair value measurements

## Relevant

Only relevant financial reporting topics included (e.g., no comprehensive income)

## Simplified

Simplified principles (e.g., no complicated derivative/hedge accounting or stock compensation rules)

## Targeted disclosures

Targeted disclosure requirements—what a user needs to see in financial statements

# Some key principles



## Consolidation

- No concept of VIEs
- Option to present parent-only financial statements

## Leases

Traditional accounting and U.S. tax code

## Revenue Recognition

Traditional—Earned and Realizable

## Goodwill/Intangibles

Amortization/no impairment testing

## Income tax accounting

Option of using taxes-payable or deferred-tax method



# What Does the Market Say?

“A new effort to streamline financial reporting could help credit officers make small-business loans without studying a mountain of footnote-laden documents.”

-American Banker,  
1/27/14

ABA  
**BANKING**  
March 2014  
JOURNAL

### New accounting framework useful tool for lenders

A new accounting option for small and mid-sized enterprises (SMEs) could be a competitive tool for banks. Or, when looked at another way, it's an option bank lenders should be aware of so as not to be at a disadvantage in prospecting for business in the SME space.

Rolled out last year by the American Institute of Certified Public Accountants (AICPA), the Financial Reporting Framework for Small- and Medium-Sized Entities is a “special purpose framework,” one of several non-GAAP accounting frameworks. GAAP accounting (generally accepted accounting principles) is required for all public and large private companies, but many other private companies can use what used to be called “other comprehensive bases of accounting,” or OCBOA. Some of these include cash basis, modified cash basis, tax basis, and regulatory basis—most of which have been around for decades. According to an AICPA spokesperson, a survey found that many SME companies needed something more than cash basis or tax basis financial statements, but didn't need to go all the way to GAAP. The new SME framework is more robust than other non-GAAP

options, without adding unnecessary complexity, the spokesperson stated. Another thing that sets apart the new framework from other non-GAAP options is that it is fully documented. A 200-page document spells it out (see link at the end of the story).

Quoting from that document, the new framework “draws upon a blend of traditional accounting principles and accrual income tax methods of accounting. It utilizes historical cost as its primary measurement basis. In addition, it provides management with a suitable degree of optionality when choosing accounting policies to better meet the needs of the end users.”

Bank lenders, of course, are one of those end users, and the spokesperson pointed out that bankers can request certain information to be included in the financial statements of clients or prospects using the new framework. Bankers also can point out to clients the availability of the new option and assist them in using it as a way to save costs or to improve financial



reporting. The AICPA has no enforcement authority over the use of special purpose frameworks by companies. The decision rests with management.

The new SME framework would *not* be applicable to banks themselves, however. The AICPA document spells out 11 “characteristics of typical entities” that may use the new framework, one of which specifically references financial institutions, which require the use of specialized accounting guidance.

To download the AICPA's SME document, go to [bit.ly/FRF-SMEs-Users](http://bit.ly/FRF-SMEs-Users)

— Bill Streeter, editor and publisher

## Competitive advantage

At my bank, our competitive advantage is connected to how we look out for our small business clients and provide them with new tools and information to evolve their businesses. By accepting FRF for SMEs, we demonstrate our knowledge, expertise and our willingness to allow multiple financial reporting options that can help small businesses make sound decisions.

–**Steve Marsh**, CEO and Chief Credit Officer

Enterprise Bank & Trust

St. Louis, MO



# Benefits

# SME owner-managers



## Owner-managers need ...

... reliable and understandable financial information to inform business decisions

... a way to control costs

**The FRF for SMEs framework delivers**

# Lending community/users

**“We’re looking for tools to help us make more informed lending decisions and potentially save small businesses money in the process. FRF for SMEs ... delivers financial statements with the information we need in a clear, concise way.”**

–Belinda Robertson, CPA  
Sr. Vice President, Loan Review  
Business First Bank  
Baton Rouge, LA

## **Bankers, sureties and other interested parties ...**

... need to get financial information that is relevant and clear so they can make informed decisions

... want to help customers realize cost-savings and efficiencies where possible

## **The FRF for SMEs framework delivers**

# Lending community/users can rely on FRF for SMEs



- CPAs across the country worked to develop the framework
- Considered the needs of users of private company financial statements
- Framework subjected to rigorous professional scrutiny and public input

# Banking regulators/acceptance



- Discussed FRF for SMEs with regulators/exam chiefs
- Bankers accept OCBOA today/flexible with smaller businesses
- Expect exam chiefs to treat FRF for SMEs as another OCBOA



# Comparisons: FRF for SMEs to Income Tax Basis of Accounting

# Comparison of FRF for SMEs to Tax Basis

- FRF for SMEs largely parallels the accrual method under the tax basis of accounting.
- FRF for SMEs provides a comprehensive and consistent financial reporting option.
- FRF for SMEs leads to a complete presentation of the entity's:
  - Financial position
  - Results of operations
  - Cash flows
  - As well as more informative disclosures

# Comparison of FRF for SMEs to Tax Basis

## Revenue & Expense Recognition

- Generally, revenue and expense recognition does not differ between the FRF for SMEs and the accrual method for income tax reporting purposes
- Sales returns
  - Tax Basis - no allowance for returns is permitted. Returns cannot be recorded until they occur.
  - FRF for SMEs - recognition of probable returns in the period the sale is recognized.
- **Some differences in accounting for long-term contracts, advanced payments, installment sales**

# Comparison of FRF for SMEs to Tax Basis Rental Income and Expense

<b>FRF for SMEs</b>	<b>Tax Basis</b>
<p>Lessees and lessors generally recognize rent under noncancellable operating leases on a straight-line method over the period the lessee controls the use of the leased property.</p>	<p>Accrual method lessors usually recognize rental income under operating leases when earned, and accrual method lessees generally recognize rent expense under operating leases when payments are due.</p>

## Comparison of FRF for SMEs to Tax Basis Receivables

FRF for SMEs	Tax Basis
Allows entities to provide an allowance for receivables for which collection is doubtful.	Must use the specific charge-off method to deduct bad debt losses related to trade notes and accounts receivable.

# Comparison of FRF for SMEs to Tax Basis

## Inventories

- FRF for SMEs - inventory is measured at the lower of cost or net realizable value.
- Tax Basis - generally allows entities to value inventory using the cost method, lower of cost or market method, or retail method.
- Under both the FRF for SMEs and tax law, cost is determined by any of the conventional cost flow assumptions.
- Some differences – inventory losses, overhead, abnormal costs.

# Comparison of FRF for SMEs to Tax Basis Investments

FRF for SMEs	Tax Basis
<ul style="list-style-type: none"><li>• Equity method is used to account for investments when investor exercises significant influence.</li><li>• Market value measurement required only for investments being held for sale.</li><li>• Changes in market value included in net income.</li></ul>	<ul style="list-style-type: none"><li>• The equity method of accounting does not exist.</li><li>• Investments in securities carried at cost.</li></ul>

# Comparison of FRF for SMEs to Tax Basis PP&E

FRF for SMEs	Tax Basis
<ul style="list-style-type: none"><li>• Depreciation recognized in a rational and systematic manner over the useful life of the asset. Depreciation expense calculated on the cost less any expected <i>residual value</i>.</li><li>• Does not recognize an expense similar to the IRC Section 179 deduction.</li></ul>	<ul style="list-style-type: none"><li>• Most property and equipment is depreciated under the Modified Accelerated Cost Recovery System (MACRS).</li><li>• IRC Section 179 deduction.</li></ul>

# Comparison of FRF for SMEs to Tax Basis Prepaid Assets

FRF for SMEs	Tax Basis
<ul style="list-style-type: none"><li>Recorded as an asset and amortized to expense.</li></ul>	<ul style="list-style-type: none"><li>Expenses paid in advance are deductible only in the year to which the expense applies, unless the expense qualifies for the “12-month rule.”</li></ul>

# Comparison of FRF for SMEs to Tax Basis Consolidation

FRF for SMEs	Tax Basis
<ul style="list-style-type: none"><li>• Consolidation is based on a threshold of more than 50 percent ownership.</li><li>• Provides more explicit guidance on accounting for a business combination, as well as subsequent consolidation.</li></ul>	<ul style="list-style-type: none"><li>• The threshold for consolidation under the IRC is 80 percent ownership.</li></ul>



# Comparisons: FRF for SMEs to U.S. GAAP

# Comparison of FRF for SMEs to U.S. GAAP Fair Value

FRF for SMEs	U.S. GAAP
Uses the term “market value” - consideration that would be agreed upon in an arm’s length transaction.	Fair value is an exit price.
<ul style="list-style-type: none"><li>• Market value used only in very limited circumstances<ul style="list-style-type: none"><li>• Business combinations.</li><li>• Certain nonmonetary transactions.</li><li>• Marketable securities held for sale.</li></ul></li></ul>	<ul style="list-style-type: none"><li>• Greater use of fair value measurements.</li><li>• Provides an overall framework to measuring fair value.</li><li>• Standardized disclosure requirements for fair value measurements.</li><li>• Nonpublic entities are exempt from certain fair value disclosures.</li></ul>

# Comparison of FRF for SMEs to U.S. GAAP Income Taxes

FRF for SMEs	U.S. GAAP
<ul style="list-style-type: none"><li>• Policy choice to account for income taxes using either the taxes payable method or the deferred income taxes method.</li><li>• No evaluation or accrual of uncertain tax positions.</li></ul>	<ul style="list-style-type: none"><li>• Deferred income tax method is used.</li><li>• Uncertain income tax positions must be evaluated and accrual made if certain conditions are met.</li></ul>

## Comparison of FRF for SMEs to U.S. GAAP Comprehensive Income

FRF for SMEs	U.S. GAAP
<ul style="list-style-type: none"><li data-bbox="123 462 877 1108">• No concept of comprehensive income or items of other comprehensive income.</li></ul>	<ul style="list-style-type: none"><li data-bbox="993 462 1673 939">• Certain items are classified as other comprehensive income (OCI) and displayed as such.</li></ul>

# Comparison of FRF for SMEs to U.S. GAAP Consolidation/Subsidiaries

FRF for SMEs	U.S. GAAP
<ul style="list-style-type: none"><li>• Policy choice to either consolidate subsidiaries or account for subsidiaries using the equity method.</li><li>• <i>Subsidiary</i> defined as an entity in which another entity owns more than 50 percent of the outstanding residual equity interests.</li><li>• No concept of variable interest entities.</li></ul>	<ul style="list-style-type: none"><li>• Consolidation is required for reporting entity with controlling financial interest in another entity.</li><li>• Variable interest entity (VIE) model is used when controlling financial interest is achieved through arrangements that do not involve voting interests.</li><li>• Common control leasing arrangements at private companies exempt from VIE model.</li></ul>

# Comparison of FRF for SMEs to U.S. GAAP Impairment

FRF for SMEs	U.S. GAAP
<ul style="list-style-type: none"><li>• No assessment of impairments for long-lived assets.</li><li>• A depreciated or amortized cost approach is followed. Assets no longer used are written off.</li></ul>	<ul style="list-style-type: none"><li>• Long-lived assets are tested for impairment upon a triggering event.</li><li>• Indefinite-lived intangible assets are subject to an impairment test annually.</li></ul>

# Comparison of FRF for SMEs to U.S. GAAP Leases

FRF for SMEs	U.S. GAAP
<ul style="list-style-type: none"><li>• Traditional accounting approach blended with some accrual income tax accounting methods.</li><li>• Lessee classifies leases as either operating or capital leases.</li><li>• Lessor accounts for leases as sales type, direct financing, or operating.</li></ul>	<ul style="list-style-type: none"><li>• Lessee classifies leases as either operating or capital leases.</li><li>• Lessor accounts for leases as sales type, direct financing, or operating.</li><li>• Project underway to revamp lease model.</li></ul>

## Comparison of FRF for SMEs to U.S. GAAP Goodwill

FRF for SMEs	U.S. GAAP
<ul style="list-style-type: none"><li>• Amortized over the same period as that used for federal income tax purposes or 15 years.</li><li>• No impairment testing.</li></ul>	<ul style="list-style-type: none"><li>• Private companies allowed to amortize over a period of 10 years or less.</li><li>• Trigger-based impairment testing.</li></ul>

# Comparison of FRF for SMEs to U.S. GAAP Revenue Recognition

FRF for SMEs	U.S. GAAP
<ul style="list-style-type: none"><li>• Broad, principle-based guidance.</li><li>• Revenue should be recognized when performance is achieved and ultimate collection is reasonably assured.</li></ul>	<ul style="list-style-type: none"><li>• Current model focuses on completion of the earnings process.</li><li>• New model issued in May 2014.</li><li>• New standard will recognize revenue when control of goods or services has passed to a customer.</li><li>• For many companies, revenue recognition may not be different, but the process the company will take to determine when to recognize revenue may change.</li></ul>

# Comparison of FRF for SMEs to U.S. GAAP Investments/Financial Assets & Liabilities

FRF for SMEs	U.S. GAAP
<ul style="list-style-type: none"><li>• Historical cost approach.</li><li>• Market value measurement required only for investments being held for sale.</li><li>• Changes in market value included in net income.</li></ul>	<ul style="list-style-type: none"><li>• Classification required based on management intent and ability.</li><li>• Securities classified as “available for sale” or “trading” measured at fair value.</li><li>• Debt securities classified as “held-to-maturity” measured at amortized cost.</li><li>• Accounting for changes in fair value depends upon classification.</li></ul>

# Comparison of FRF for SMEs to U.S. GAAP Derivatives

FRF for SMEs	U.S. GAAP
<ul style="list-style-type: none"><li>• Disclosure approach.</li><li>• Recognition at settlement (cash basis).</li><li>• No hedge accounting.</li></ul>	<ul style="list-style-type: none"><li>• All derivatives recognized as either assets or liabilities.</li><li>• Measured at fair value.</li><li>• Accounting for changes in fair value depends on the use of the derivative.</li><li>• Hedge accounting permitted.</li><li>• Simplified hedge accounting for plain-vanilla interest rate swaps allowed for private companies.</li></ul>

# Comparison of FRF for SMEs to U.S. GAAP Stock-based Compensation

FRF for SMEs	U.S. GAAP
<ul style="list-style-type: none"><li>• Disclosure only.</li></ul>	<ul style="list-style-type: none"><li>• Stock-based compensation is classified as “Liability” or “Equity”.</li><li>• Accounting for stock-based compensation expense depends upon classification.</li><li>• Measurement of stock-based compensation is fair-value based.</li><li>• Private companies permitted to measure stock-based compensation under “calculated-value method”.</li><li>• When it is not possible to reasonably estimate fair value or calculated value, intrinsic value is permitted.</li></ul>

# Comparison of FRF for SMEs to U.S. GAAP Defined Benefit Plans

FRF for SMEs	U.S. GAAP
<ul style="list-style-type: none"><li>• Policy choice to account for plans using either a current contribution payable method or one of the accrued benefit obligation methods.</li></ul>	<ul style="list-style-type: none"><li>• Plans accounted for using a projected benefit obligation model.</li></ul>



# Appendix – Extracts from Illustrative Financial Statements

# Example Financial Statement Extracts

- Example assumes primary difference between FRF for SMEs and GAAP financial statements is that management uses “taxes payable” method rather than “deferred taxes” method
- Deferred tax balances account for differences in financials

# Statement of Financial Position

## Extract from Current Assets

Assets	FRF for SMEs	GAAP
Cash and cash equivalents	\$ 304,400	\$ 304,400
Accounts receivable	3,789,200	3,789,200
Inventory	89,700	89,700
Prepaid charges and other assets	<u>118,400</u>	<u>118,400</u>
Total current assets	\$ 4,301,700	\$ 4,301,700

# Statement of Financial Position

## Extract from Long-term Assets

Assets	FRF for SMEs	GAAP
Equity in joint venture	\$ 205,600	\$ 205,600
Note receivable, related party	175,000	175,000
Property and equipment net of accumulated depreciation	<u>976,400</u>	<u>976,400</u>
Total long-term assets	1,357,000	1,357,000

# Statement of Financial Position

## Extract from Current liabilities

Liabilities	FRF for SMEs	GAAP
Current maturities of notes payable	\$ 110,300	\$ 110,300
Current portion of leases payable	62,250	62,250
Accounts payable	2,543,100	2,543,100
Current deferred tax liability		594,000
Other accrued liabilities	<u>88,600</u>	<u>88,600</u>
Total current liabilities	\$ 2,804,250	\$ 3,389,250

# Statement of Financial Position

## Extract from Long-term liabilities

Liabilities	FRF for SMEs	GAAP
Notes payable, less current maturities	\$ 357,800	\$ 357,800
Leases payable, less current portion	135,350	135,350
Long-term accrued liabilities	<u>154,200</u>	154,200
Deferred tax liability		<u>25,200</u>
Total long-term liabilities	\$ 647,350	\$ 672,550

# Statement of Financial Position

## Extract from Shareholders' Equity

Equity	FRF for SMEs	GAAP
Common stock - \$1 par value, 500,000 authorized shares...	\$ 300,000	\$ 300,000
Retained earnings	1,907,100	1,287,900
Total shareholders' equity	<u>2,207,100</u>	<u>1,587,900</u>
Total liabilities and shareholders' equity	\$ 5,658,700	\$ 5,658,700

# Extract from Statement of Operations

Equity	FRF for SMEs	GAAP
Revenues earned	\$ 9,630,800	\$ 9,630,800
Cost of revenues earned	<u>7,436,100</u>	<u>7,436,100</u>
<b>Gross profit</b>	2,194,700	2,194,700
Selling, general, and administrative expense	<u>895,600</u>	<u>895,600</u>
Income from operations	1,299,100	1,299,100
Gain on sale of equipment	10,000	10,000
Interest expense	<u>(69,500)</u>	<u>(69,500)</u>
Income before provision for income taxes	1,239,600	1,239,600
Provision for income taxes	<u>451,700</u>	<u>662,900</u>
<b>Net income</b>	787,900	576,700

# Extract from Statement of Cash Flows

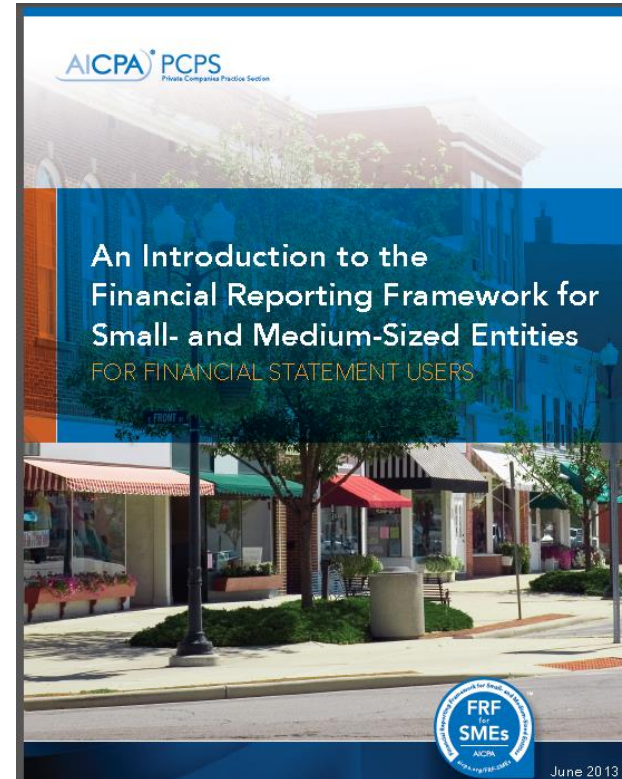
Cash flows from operating activities	FRF for SMEs	GAAP
Net income	\$ 787,900	\$ 576,700
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	167,800	167,800
Provision for losses on receivables	6,300	6,300
Gain on sale of equipment	(10,000)	(10,000)
Increase in deferred taxes		211,200
Increase in long-term accrued liabilities	128,000	128,000
Decrease in inventory	9,400	9,400
Increase in accounts receivable	<u>(461,400)</u>	<u>(461,400)</u>
<b>Net cash provided by operating activities</b>	628,000	628,000



[Learn More](#)

# Toolkit for your use/ your staff

- Plain English introduction
- Video
- Illustrative financial statements
- Comparisons to other bases of accounting
- Backgrounder
- Flyer
- FAQs
- PowerPoint to introduce FRF SMEs to others



[aicpa.org/FRF-SMEs](http://aicpa.org/FRF-SMEs)

# Toolkit for educating small businesses

- Plain English introduction
- Video
- Illustrative financial statements
- Comparisons to other bases of accounting
- Decision tool
- Backgrounder
- Flyer
- FAQs
- PowerPoint
- Letter for stakeholders

## FRF for SMEs™ Toolkit for Small Business

The AICPA has created numerous resources to help small businesses understand the new *Financial Reporting Framework for Small- and Medium-Sized Entities* (FRF for SMEs™ accounting framework). Learn how it could help private companies and users of their financial statements make informed business or credit decisions when GAAP financial statements are not needed.

FRF for SMEs™ Accounting Framework  
*Robust. Relevant. Reliable.*



Get a free copy of the framework (PDF) FRFforSMEs@aicpa.org  
#MainSIFinancials

### Resources

- An *Introduction to the Financial Reporting Framework for Small- and Medium-Sized Entities* is a primer on the FRF for SMEs™ reporting option.
- An animated video highlights the evolution of the framework and some of the FRF for SMEs™ accounting framework's key benefits. ([View or download in BrightCove format](#) or [download wmv format](#) for use in PowerPoint slides—

[aicpa.org/FRF-SMEs](http://aicpa.org/FRF-SMEs)



# Questions?

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

FRF for SMEs™ Accounting Framework

# Reference and source

- Business Model Innovation Strategy: Transformational Concepts and Tools for Entrepreneurial Leaders – Illustrated, October 13, 2020 by Raphael Amit (Author), Christoph Zott (Author)
- Innovation Strategy: Seven Keys to Creative Leadership and a Sustainable Business Model by Howard Rasheed Ph.D | May 16, 2012
- RESTART Sustainable Business Model Innovation (Palgrave Studies in Sustainable Business In Association with Future Earth) Part of: Palgrave Studies in Sustainable Business In Association with Future Earth (10 Books) | by Sveinung Jørgensen and Lars Jacob Tynes Pedersen | Jul 31, 2018
- End-to-End M&A Process Design: Resilient Business Model Innovation by Thorsten Feix | Jul 8, 2020
- Business Model Innovation: Concepts, Analysis, and Cases by Allan Afuah | Oct 3, 2018