# Audit Insights

## Helping You Succeed

ACCUITY

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# Accounting methods: Private companies have options

Businesses need financial information that's accurate, relevant and timely. The Securities and Exchange Commission requires publicly traded companies to follow U.S. Generally Accepted Accounting Principles (GAAP), often considered the "gold standard" in financial reporting in the United States. But privately held companies can use simplified alternative accounting methods. What's right for your business depends on its size, regulatory and contractual requirements, management's future plans and the needs of its stakeholders.


### MENU OF ACCOUNTING METHODS

Here's an overview of the accounting methods available for small and medium-sized entities (SMEs):

**GAAP.** This framework follows rules set forth by the Financial Accounting Standards Board (FASB). It's based on the accrual method of accounting, where revenues and expenses are matched to the reporting period in which they're earned and incurred, respectively. Under this method, companies report *receivables* for revenue that's earned but not yet collected and *payables* for expenses that are incurred but not yet paid. Prepaid (and accrued) expenses are also reported on an accrual-basis balance sheet.

**Financial reporting framework for SMEs.** This framework is rooted in GAAP, but it's adjusted to accommodate the needs of private businesses. Developed by the American Institute of Certified Public Accountants (AICPA), this simplified framework blends traditional accounting principles with accrual-basis income tax accounting methods.

This non-GAAP framework is based on historic cost, steering away from complex, fair-value-based standards that have been implemented in recent years. For example, it retains the familiar accounting for revenue recognition and leases. It also includes targeted disclosure requirements and provides a degree of optionality, enabling SMEs to customize their financial statements to meet the needs of stakeholders.

**Tax basis method.** Under this method, companies use the same accounting principles for book and federal income tax purposes. The U.S. tax code provides the rules that apply under this method.

**Cash-basis method.** This is the simplest reporting method. Revenues are recognized when received from customers and expenses when the company pays them. But there's a potential downside: Revenues for the period aren't necessarily matched to the related expenses for the period. This can lead to fluctuations in profits and financial ratios when comparing performance over time.

## QUESTIONNAIRE

Discuss the following questions with your accounting professional to help select the right method for your business:

- How big is your business?
- How quickly is it growing?
- Who will use its financial statements and for what purpose?
- Do you plan to raise capital?
- Do you plan to apply for debt financing?
- Do you anticipate changes in the revenue your business generates, the products and services it offers, or the area it serves?
- Are you planning to sell the business or merge with another business?

For example, the cash- or tax-basis method may be appropriate for a single-owner business without any debt that uses its financial statements for internal purposes only. But larger private firms may decide it's advantageous to comply with GAAP to attract outside investors, obtain loans, satisfy bonding and regulatory requirements, and evaluate strategic business decisions.

## WHAT'S RIGHT FOR YOU?

As your business grows in size, sophistication and complexity, it may be time to upgrade to a more complicated and consistent method of accounting. Contact us to help select a reporting framework that suits your current needs.