Mid-market perspectives

Tailoring U.S. GAAP for private company financial reporting

A closer look at the FAF's proposed Private Company Standards Improvement Council

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Addressing private company financial reporting needs

The wheels are in motion to finalize a new structure to more specifically address the financial reporting needs of private companies. Many business leaders believe that U.S. generally accepted accounting principles (U.S. GAAP) are currently tailored more for public companies, but there's no consensus on the best way to set new standards that will provide useful, relevant information that reflects the operational performance and financial position of private companies.

The Financial Accounting Foundation (FAF) could meet as early as May 2012 to discuss a final structure and plan for addressing private company financial reporting. The FAF has proposed creating the Private Company Standards Improvement Council (PCSIC or Council) that would recommend changes to U.S. GAAP for private companies. This proposal has spurred heated debates among private company stakeholders.

In this publication, we address:

- The case for different private company standards,
- Background: the long road to the current proposal,
- FAF's proposed Council, and
- Stakeholder perspectives on the proposed Council.

The case for different private company standards

Critics of the current U.S. GAAP standards contend that users of private company financial statements—typically lenders, venture capitalists, major suppliers, and other creditors—have different needs than the primary users of public company financial statements, which include a broad array of investors and financial analysts. Also, private company users often have direct access to management, which makes these users less reliant on financial statements and other published information than many public company investors and financial analysts.

Private company users often need to understand the company's historical earnings, as well as its current financial position, to evaluate the company's ability to repay credit, perform under a contract, or make an investment decision in illiquid markets. On the other hand, investors and financial analysts seek to value debt or equity securities in highly liquid markets using concepts and tools of financial economic theory. Indeed, some critics point to these financial economic principles as a key contributor to the many fair value requirements that may not provide significant benefit to users of private company financial statements.

In summary, proponents of different standards for private companies are concerned about:

- **Lack of relevance and usefulness of financial information.** Many feel that current accounting standards often do not provide relevant information regarding private company operations or financial position. These market participants cite items, such as recording non-cash charges from stock compensation or the fair value of a derivative asset or liability, as extraneous information that does not help a user analyze the earnings and/or financial position of a private company. Many users of private company financial statements report that they routinely adjust the financial statement information to suit the users' particular needs.

- **Increased complexity.** U.S. GAAP standards are becoming increasingly complex, stretching the technical capability of finance and accounting departments of many privately held companies beyond their capacity. And the pace of standard setting shows no sign of slowing down. For example, significant new pronouncements for revenue recognition, leases, and financial instruments will likely further complicate the lives of private company preparers and users.

- **Costs that outweigh benefits.** Many critics of U.S. GAAP believe the benefits of implementing and maintaining some of the more complex standards—such as accounting and disclosure requirements for uncertain tax positions or determining the fair value of a complex derivative—are not worth the cost.

- **Acceptance of qualified reports and use of alternative standards.** There is evidence that the number of qualified opinions is increasing. For example, a private company's bank may agree to accept an audit opinion qualified for the non-consolidation of a variable interest entity, such as a related leasing entity. There are also reported increases in private companies using another comprehensive basis of accounting, such as tax basis financial statements. Critics of the current state of U.S. GAAP point to these developments as evidence that U.S. GAAP may not be generally accepted after all.

Of course, the increasing complexity and cost of U.S. GAAP is a burden on both public and private companies. The Financial Accounting Standards Board (FASB) has made recent efforts to reduce complexity for all users, for example, allowing public and private companies, in appropriate circumstances, to avoid the cost and complexity of annual step-one testing of goodwill and is proposing to do the same for other indefinite-lived intangibles.

Background: the long road to the current proposal

2005: AICPA survey calls for change

In 2005, the American Institute of Certified Public Accountants (AICPA) founded a taskforce that was charged with determining whether or not financial reports that conform to GAAP standards meet the needs of private company users. The taskforce conducted a survey of diverse users of private company financial statements, including owners, Certified Public Accountants (CPAs), lenders, venture capitalists, and sureties.

Among the findings, the survey results showed that the attributes of GAAP reporting were generally valued by private company constituents and that having one source of accounting principles that is generally accepted was important to them. However, the respondents reported that many GAAP-specific requirements were not relevant or useful to them. Finally, many stated that it would be useful to have different measurement and recognition guidance between private and public companies in certain cases.

One conclusion of the taskforce was that U.S. GAAP reporting requirements should be different for private company constituents to meet their distinct needs. The task force also recommended that fundamental changes should be made to the GAAP standard setting process in the U.S. to better meet the needs of private company constituents.

2006: Limited influence of the Private Company Financial Reporting Committee (PCFRC)

In 2006, the FASB and the AICPA formed the PCFRC to help improve the FASB's standard-setting process to consider the needs of private companies and their users. The PCFRC's primary mission is to provide recommendations to the FASB with respect to differences in existing and prospective GAAP for private companies.

Currently, the PCFRC consists of four financial statement user members: a surety, a venture capitalist, and two commercial bank lenders; four preparers; and four practicing CPAs. The PCFRC has held over 27 public meetings and provided formal recommendations or comment letters on over 50 topics. For example, the PCFRC recommended that the FASB consider different recognition and measurement criteria for uncertain tax positions for private companies under what was then known as FIN 48, *Accounting for Uncertain Tax Positions*. The FASB responded by delaying the implementation date of FIN 48 for private companies, providing them with some relief from its disclosure requirements.

In April 2009, the PCFRC issued a paper discussing and recommending solutions to address private company financial reporting. While the PCFRC members had very different views on the recommendations, there was a unanimous view that U.S. private company financial reporting needed to be addressed.

2009-2011 Blue Ribbon Panel recommendations

In 2009, FAF trustees and senior FAF leaders conducted a "listening tour" to meet with diverse groups of constituents to understand their views on the independent standard-setting process and the key issues affecting financial reporting, including concerns about the cost and complexity of standards for private companies.

As a result, the FAF, in collaboration with the AICPA and the National Association of State Boards of Accountancy (NASBA), created the Blue Ribbon Panel, which was charged with studying and making recommendations to FAF trustees about how to improve the standard-setting process for private companies. The Blue Ribbon Panel submitted its report to the trustees in January 2011.

Among other things, the Panel concluded that there were growing systemic issues that needed to be addressed in the current system of U.S. accounting standard setting, particularly in understanding the needs of users of private company financial statements and weighing the costs and benefits of GAAP for use in private company financial reporting. Panel members concluded these issues caused a lack of relevance and too much complexity for preparers of private company financial statements and their CPA practitioners.

The following are the Blue Ribbon Panel's most significant recommendations:

- **Modify—not replace—U.S. GAAP for private companies.** The Panel did not recommend creating a separate "self-contained GAAP" for private companies, as some other countries have done. Instead, they recommended continued use of U.S. GAAP with exceptions and modifications to better meet the needs of private company users.

- **Create a private company standards board.** The Panel proposed a private company standards board separate from the FASB, but under the FAF's oversight, to help ensure that appropriate and sufficient exceptions and modifications are made to new and existing U.S. GAAP standards. This new board would work closely with the FASB to develop an efficient standard-setting process, but would have final authority over exceptions and modifications. The board's effectiveness would be reviewed in three to five years, with changes made then if needed.

- **Develop a framework for evaluating costs and benefits.** A differential framework would be created that would allow the new board to evaluate the costs and benefits to private company users of proposed U.S. GAAP exceptions or modifications.

The FAF created a working group to evaluate the Blue Ribbon Panel's findings. They conducted a series of stakeholder meetings, including representatives of large, mid-market, and small CPA firms who serve private companies and not-for-profit organizations. Additionally, they reviewed approximately 2,800 unsolicited letters, most of which supported the Panel's recommendation for a separate standard-setting board for private companies.

The findings of the working group led the FAF to propose the formation of a new standard-setting body: the Private Company Standards Improvement Council (PCSIC). The FAF recognized that more attention should be paid to users of private company financial reports and that the FASB has too many competing priorities to adequately focus on this need.

Major players in the private company reporting debate

The Financial Accounting Foundation (FAF) was established in 1972 as an independent private-sector organization with responsibility for establishing and improving financial accounting and reporting standards. The FAF is the parent organization of the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). FAF has delegated authority for establishing financial accounting and reporting standards for private sector entities to the FASB.

The American Institute of Certified Public Accountants (AICPA) was founded in 1887 and sets ethical standards for the profession and U.S. auditing standards for audits of private companies, non-profit organizations, and federal, state, and local governments. Until the organization of the FAF, U.S. GAAP was established by the Accounting Principles Board,which was a senior committee organized within the AICPA.

The National Association of State Boards of Accountancy (NASBA) was founded in 1908 to enhance the effectiveness of the country's state boards of accountancy by creating a forum for accounting regulators and practitioners to address issues relevant to the viability of the accounting profession.

The Private Company Financial Reporting Task Force (PCFR Task Force) was formed by the AICPA in 2005 to determine whether financial reports of private entities prepared in conformity with GAAP met the needs of users. The Task Force conducted a statistically unbiased survey of diverse users of private company financial statements, including owners, CPAs, lenders, venture capitalists, and sureties.

The Public Company Financial Reporting Committee (PCFRC) was formed as a result of the PCFR Task Force survey findings. The FASB and the AICPA established the committee in 2006 to improve the FASB's standard-setting process to consider the needs of private companies and their users. The PCFRC's primary goal is to provide recommendations to the FASB about differences in existing and prospective GAAP for private companies.

The FAF's proposed Council

The FAF's proposal includes forming a new body called the Private Company Standards Improvement Council (the "Council"). The Council would focus solely on private companies and the needs of the users of their financial reports. The Council would have the power to propose exceptions or modifications to current U.S. GAAP and future accounting standards updates for private companies.

Its power would not be unilateral. To create a checkpoint and to foster collaboration, the FASB would be asked to ratify changes proposed by the Council. To facilitate the process, the Council and the FASB would develop a framework for evaluating U.S. GAAP modifications and exceptions, based on key characteristics that differentiate the needs of users of private company financial reports from the needs of users of public company financial reports.

Council membership

Under the proposal, the Council would fall under the oversight of the FAF, the same organization that oversees the FASB. FAF trustees would select a chairperson and up to 15 members. The current proposal suggests that the Council's chairperson would be a FASB board member to maintain the connection with the FASB. While not a requirement, a prime candidate for the Council's chairperson would be the FASB's private company preparer member, one of two new FASB positions that were added in 2011. The remaining council members are likely to be a diverse group, including financial statement users, preparers, and practitioners with significant experience working with private company financial statements. The FAF may also attempt to diversify the Council by selecting members representing different size companies and industries.

The intention is that council members would sit for an initial three-year term, with the ability to be reappointed by the FAF for two additional one-year terms, for a maximum total of five years. However, it is possible that the initial members may have varying terms so that the FAF will be able to stagger the appointment of future members.

The proposal states that the FASB will devote staff to support the Council and its projects. Staff will be needed to perform research, conduct outreach, write position papers, and write exposure drafts and accounting standards updates. While the FASB currently has some designated staff members to support private company issues, many stakeholders believe that more will be needed for the Council to function effectively.

Council meetings

One of the models for the Council was the Emerging Issues Task Force (EITF), so there are several similarities between this organization and the proposed Council. It is expected that the Council would probably meet at the FASB's Norwalk, Connecticut offices four to six times a year, approximately the same number as the EITF, with possibly more meetings during its inaugural year. The Council's meetings will be open to the public and would probably be presented as webcasts, similar to the EITF.

Additionally, FASB board members would be invited to attend these meetings, as they attend EITF meetings. While this may concern some, the FASB board members have been very helpful in the EITF deliberations. They ask insightful questions and express any potential concerns upfront so the EITF can address them before submitting a proposal for ratification.

Council responsibilities

The Council would be responsible for developing the criteria that would be used for considering potential differences in U.S. GAAP for public and private companies. Following this criteria, the Council would propose exceptions or modifications to U.S. GAAP for private companies.

Council's influence on current projects. The Council may deliberate the same issues as the FASB, vote on whether deviations from public company requirements are appropriate, and provide these views to the FASB. Under this proposed model, the FASB would be able to consider the Council's advice, determine if a change for public companies is also warranted, and make appropriate provisions before an exposure draft of a final accounting standards update is issued. As a result, the private company concerns would be considered throughout the project and not as an afterthought.

What if the FASB's future role changes? The U.S. Securities and Exchange Commission (SEC) is considering whether to incorporate International Financial Reporting Standards (IFRS) into financial reports for public U.S. companies. Based on comment letters to the SEC, the preferred approach seems to be that public U.S. companies would continue to follow U.S. GAAP, with the FASB deciding whether to endorse incorporating existing or new international standards. If this happens, the Council would play an important role in evaluating whether or not IFRS incorporation would meet the needs of private companies and their users.

Modification of existing GAAP standards. The Council would be responsible for reaching out to users of private companies to identify and prioritize areas of U.S. GAAP that should be considered for modification. The Council may also find areas that are unnecessarily complex for public companies as well as private ones. A close working relationship between the Council and the FASB can potentially benefit all companies.

Of course, there will be instances where an accounting requirement is necessary for public companies but not for private companies. In these situations, the Council would deliberate the issues, make proposals to modify U.S. GAAP, and solicit constituent feedback. After gathering comments, they would deliberate the issue again, update standards as needed, and vote on final changes. Changes approved by the Council would be subject to FASB ratification. However it's important to remember that FASB members will attend the deliberations, so the Council would have the opportunity to address FASB concerns before voting.

Council Oversight

The FAF would be responsible for overseeing the Council, just as they oversee the FASB and the GASB, the governmental standards board. The FAF's oversight role does not mean questioning or second-guessing the technical decisions of the standard setter; instead, the FAF is responsible for making sure the standard setter fully follows due process and that the process is effective.

As a result, the Council would periodically report to the FAF to provide updates on their progress in fulfilling their responsibilities. The FAF would evaluate the effectiveness of the Council's structure and processes and make changes as necessary. The FAF would also perform post-implementation reviews of the Council's standards, similar to recent FASB reviews, to confirm that the Council's objectives are being met.

While not specifically mentioned in the proposal, the FAF would also oversee the FASB's conduct in the process to ensure that the FASB uses its powers appropriately with respect to ratification and participation in the process.

Stakeholder perspectives on the proposed Council

The FAF proposal to form the Council was open for public comment for more than 90 days, and ended on January 14, 2012. The FAF also sponsored four nationwide roundtable discussions between January and March 2012.

Numerous stakeholders have supported the proposal. And, as expected, the proposal also has its detractors. For example, Senator Carl Levin of Michigan wrote a letter to the FAF noting his opposition to having any body create separate private company standards. He indicated that there should be a single set of rigorous standards for both public and private companies to protect the interests of investors. He believes a reduction in transparency is a likely outcome of having an organization set separate private company standards.[1] This is an exception, as most detractors support having a body creating separate private company standards and stated the FAF's proposal does not go far enough to meet their objective. Generally, they do not agree with the FAF's few changes to the recommendations of the Blue Ribbon Panel.

Following are some of the primary issues raised by supporters and detractors in the comment letters and roundtables:

- **Ratification:** Some constituents agree with the FASB's proposed role in ratifying Council proposals. Others disagree and believe the Council should be an independent body with only FAF oversight.

- **Chairman and membership:** Some constituents believe the Council's chairperson should not be a FASB board member, but instead, should be an independent party to provide further separation from the FASB. Others proposed having co-chairs with one chairman from the FASB and the other being independent. There are also diverse views on the number of members that would make up the Council. Some believe that 15 members would be cumbersome and propose having fewer members. Others believe that the proposal is about the right number needed to perform the significant outreach that will be necessary. There does not appear to be significant support for more than 15 members.

- **Staffing:** Stakeholders generally agree that the Council will need a sufficient number of staff members whose focus is on private companies. However, this presents an unresolved issue: how will the FAF fund the Council and an adequate staff?

- **Meetings:** Some constituents note that four to six meetings a year may be adequate in the long term, but that significantly more meetings will be necessary in the beginning. The EITF, a model for this proposal, met almost every month at the beginning of its operations.

- **Agenda:** The proposal does not address how the Council's agenda would be set. Some have asked how potential differences to U.S. GAAP will be added to the Council's agenda for consideration. One suggestion is similar to the EITF's process: the FASB's chairman would set the FASB and EITF agenda, as well as the Council's agenda, with input from FASB and Council members. A more popular suggestion proposes that the Council, with input from FASB members, establishes its own agenda.

- **Differential framework:** A number of constituents supported the development of a differential framework—one that identifies how the needs of users of private and public company financial reports differ and how that may play into creating different accounting standards.

[1] Financial Accounting Foundation, PCSIC comment letter number 201. http://www.accountingfoundation.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175823574629&blobheader=application%2Fpdf

Deloitte's position on the proposal

Deloitte is generally supportive of the FAF proposal. U.S. GAAP remains a set of high-quality accounting standards for all non-governmental entities, and it does not make sense to throw these standards away. While not perfect, U.S. GAAP has served many private companies well, and few, if any, want to lose these benefits. With these considerations in mind, the aim of this proposal is to appropriately modify these standards with a more specific focus on the needs of users of private company financial reports. The Council's primary role would be to gather and understand the concerns of private company preparers, auditors, and users of financial reports. This organization would become a catalyst in setting accounting standards for private companies.

However, users will not be well served by unnecessary differences between financial reports of public and private companies, which would create undue costs and difficulty for users, auditors, and preparers. For users, it would diminish comparability; for preparers, it would add complexity for private companies that anticipate going public and for public companies that have significant investments in private companies.

The FAF proposed process minimizes unnecessary divergence from U.S. GAAP by ensuring that the FASB and the Council work closely together, sharing a conceptual framework and standards. If the Council identifies an improvement that would also benefit public companies, the structure allows the Council and FASB to deal with the issue for the benefit of all companies. Because the Council's proposed modifications are subject to FASB ratification, there is a check to ensure that modifications are not made solely for the sake of creating separate private company standards.

More importantly, we believe FASB ratification will benefit private companies by adding additional credence to U.S. GAAP modifications. The FASB has a long, positive history, and is well respected among the user community. FASB's approval of a standard would add to the acceptance of a proposal from the new Council.

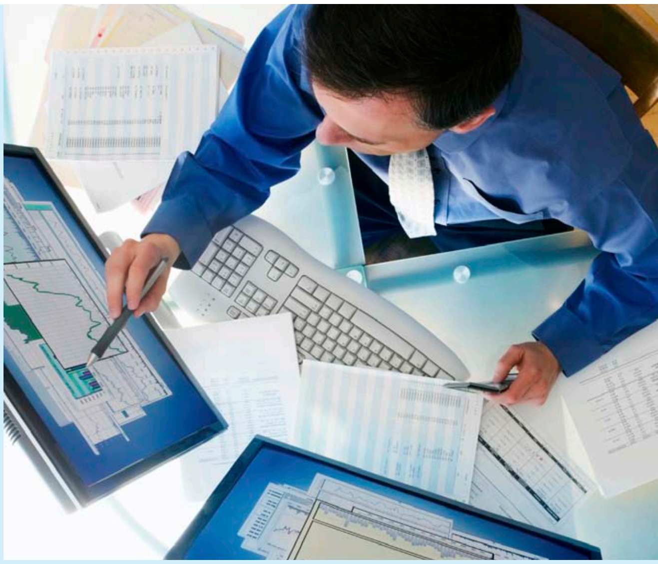
In summary, we believe the Council's structure would provide appropriate balance to help ensure that important private company issues are addressed while avoiding unnecessary changes, which would be harmful. However, we believe the following factors are critical to the Council's effectiveness:

- **Active oversight.** The FAF must be active in its oversight role and ensure there are checks and balances, including ensuring that the FASB does not inappropriately use its power over ratification.

- **Effective framework.** The proposal requires an effective framework for evaluating proposed U.S. GAAP exceptions or modifications for private companies.

- **High-quality Council members and support.** The FAF must select highly qualified members with significant experience in private company issues and devote adequate staff resources. Also, the Council must be able to direct the activities of this staff that is devoted to private company issues as their highest priority.

- **Agenda autonomy.** It is our view that the Council should have some autonomy in setting its own agenda.



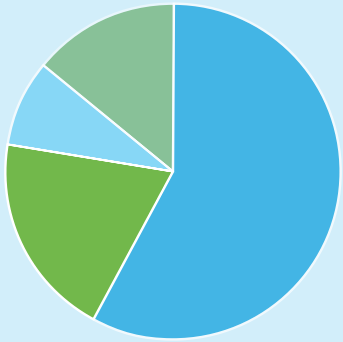
Poll results from Deloitte's Dbriefs webcast

This publication is based on Deloitte's Dbriefs webcast, *Private Company Financial Reporting Update: Taking a Closer Look at the PCSIC,* which was presented by the authors on February 29, 2012. More than 2,000 participants attended. During the presentation, the participants were asked to respond to poll questions to gather insight into their opinions regarding the FAF's proposed Council.

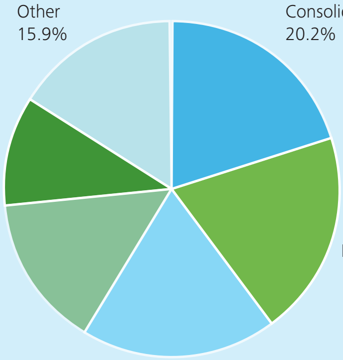
The poll results showed that most of the attendees were preparers of financial statements (58%), and nearly 20% are users of financial statements. Most (55%) felt that the cost and complexity of complying with U.S. GAAP is the issue that concerns them most, while almost one-fourth (23%) believed the usefulness of financial statements to key stakeholders is the greatest issue. When asked which area of U.S. GAAP the Council should address first, the participants identified consolidations (20%), derivatives (19%), and uncertain tax positions (18%). The majority (54%) of the participants felt that the FAF should proceed with its proposal to create the Council.

Below are the complete results.

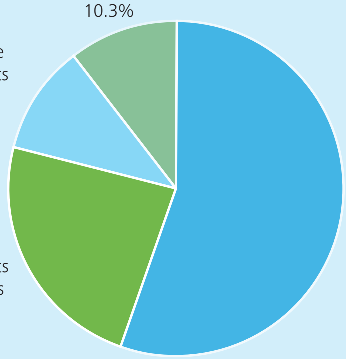
Which of the following best describes you?



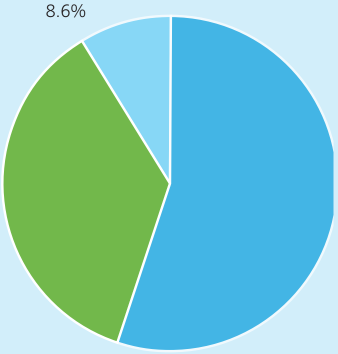
What area of current U.S. GAAP should be addressed first by the Council?



What do you feel is the greatest issue facing private companies as it relates to applying U.S. GAAP?



Do you feel that the FAF should proceed forward with its proposal to create the PCSIC?



The future of private company reporting

As of April 2012, the FAF is still considering the comments submitted by its private company constituencies and deliberating the proposed structure of the Council. The FAF could reach a decision as early as May on a final structure to address accounting standards used for private company financial reports.

In the meantime, the FASB has two pertinent projects. First, the FASB chairman recently added a project to define private companies. Currently, U.S. GAAP has differing definitions of non-public entities depending on the accounting topic. This project would clarify the definition and the entities the Council's standards would affect. Second, the FASB continues to devote staff towards the development of a private company decision-making framework.

We will continue to follow the FASB's deliberations regarding the proposed Council, and will report future developments.

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