



A Closer Look

Discussion and Analysis of Current Accounting and Audit Issues



CCH

a Wolters Kluwer business

ACCOUNTING RESEARCH MANAGER®

ISSUE 2011-1 • APRIL 6, 2011

Accounting Battle for the Ages — Big GAAP, Little GAAP

"The latter half of the decade ... was a period of unprecedented stress for the individual members and institutions of the accounting profession. Problems arising from ... the development of increasingly complex and innovative business practices ... [have] create[d] a wave of criticism of corporate financial reporting. This criticism came both from within and outside the profession ..."

The Wheat Report, March 1972

Introduction

On March 4, 2011, the Trustees of the Financial Accounting Foundation (FAF) announced the creation of a Trustee Working Group to address issues associated with standard setting for nonpublic companies. The FAF is charged with the oversight and administration of the Financial Accounting Standards Board (FASB) and its Advisory Councils. The formation of the Working Group comes in response to the "Report to the Board of Trustees of the Financial Accounting Foundation" (Report) issued on January 26, 2011, by the Blue-Ribbon Panel on Standard Setting for Private Companies (Blue-Ribbon Panel).

According to the Report, the Blue-Ribbon Panel was formed in December 2009 "to

address how accounting standards can best meet the needs of users of U.S. private company financial statements." The Blue-Ribbon Panel represents a collaborative effort of the FAF, the American Institute of Certified Public Accountants (AICPA), and the National Association of State Boards of Accountancy (NASBA). The Report is the culmination of that effort and presents the Blue-Ribbon Panel's recommendations to the FAF Trustees.

This issue of "A Closer Look" summarizes the Blue-Ribbon Panel's recommendations and presents an analysis of its conclusions. It also examines other issues related to private company financial reporting and explores the likely direction of the Trustee Working Group.

Brief History of Differential Reporting Efforts

"Little GAAP," "Baby GAAP," and "FASB Lite" are all terms that have been used to describe a differential set of accounting and reporting standards for smaller entities feeling overburdened by the rigors of current and proposed U.S. GAAP. The discussion of the need for differential standards for smaller, nonpublic entities predates the Blue-Ribbon Panel by decades.

From the AICPA's 1972, "Report of the Study on Establishment of Accounting Principles" (the

“Wheat Report” cited at the beginning of this issue), to the Blue-Ribbon Panel’s Report, the task of improving the standards for financial accounting and reporting has been the subject of seemingly endless study and debate. An integral part of that scrutiny has been focused on the needs of users of the financial statements, and whether a single set of accounting standards can meet those needs for financial statements prepared by entities of all sizes — both public and private — while not imposing an unreasonable burden on the preparers of those statements.

The most recent attempts to address the issue of the reporting needs of smaller companies came first in 2004 and then again in 2006. The FASB established the Small Business Advisory Committee in 2004 to “obtain more active involvement by the small business community in the development of financial accounting and reporting standards.” The Committee meets twice yearly and is currently composed of 22 members representing users, preparers, and auditors in the small business community.

The most recent attempts to address the issue of the reporting needs of smaller companies came first in 2004.

In June 2006, the FASB issued an Invitation to Comment, “Enhancing the Financial Accounting and Reporting Standard-Setting Process for Private Companies.” The Invitation was a joint proposal by the FASB and the AICPA, and the response by the FASB was the formation of the Private Company Financial Reporting Committee (PCFRC). The PCFRC held its first meeting in April 2007.

The PCFRC represents nonpublic business entities of all sizes and is intended to provide

the FASB with input on the needs of private companies and the users of their financial statements. The PCFRC is sponsored by the FASB and consists of a chairman and four financial statement users, four preparers, and four CPA practitioners. The PCFRC sets its own agenda and makes specific technical recommendations for possible modifications for private companies to existing or developing FASB standards.

In a letter dated November 2, 2009, the PCFRC recommended “that the FAF consider the issue of U.S. private company accounting in the context of the mission of the FASB.” The letter continued by stating the PCFRC’s belief “that a separate, stand-alone set of accounting standards for U.S. private companies tailored to the needs of the users of those statements is the preferred approach.” The Blue-Ribbon Panel was formed, in part, to address the concerns identified by the PCFRC.

The Blue-Ribbon Panel’s Recommendations

The Blue-Ribbon Panel was composed of financial reporting constituencies, including lenders, investors, and owners as well as preparers, auditors, and regulators. Blue-Ribbon Panel members included FAF President and CEO Teresa S. Polley, AICPA President and CEO Barry C. Melancon, and NASBA Chairman Billy M. Atkinson.¹ The two principal recommendations of the Blue-Ribbon Panel were straightforward: (1) U.S. GAAP should have exceptions and modifications for private companies; and (2) those exceptions and modifications should be determined by a separate private company accounting standards board.

GAAP with Exceptions

The Blue-Ribbon Panel expressed its belief that appropriate modifications and exceptions to

¹ Mr. Atkinson was the 2009–2010 Chairman of NASBA and continues to serve on the NASBA Board of Directors.

existing GAAP should be made to better meet the needs of users of private company financial information. Under the model proposed by the Blue-Ribbon Panel, private company accounting standards would be based on existing U.S. GAAP that is modified as necessary during the standard-setting process. The model is based on the continued use of U.S. GAAP for public and private companies, with exceptions and modifications made for private companies and consideration given to balancing costs and benefits. The result would be different measurement, disclosure, presentation, and recognition standards for private companies.

The model is based on the continued use of U.S. GAAP for public and private companies, with exceptions and modifications made for private companies.

The development of modifications and exceptions for private companies would be based on the creation of a differential framework to enable a separate private company accounting standard-setting board to evaluate whether such exceptions or modifications are needed. This differential framework would serve as a guide to evaluate whether the resulting differences would be appropriate, rather than as an entirely new foundation from which to develop a separate body of GAAP for private companies.

Separate Standards Board

The Blue-Ribbon Panel also recommended that the FAF create a separate accounting standards board with the ultimate

standard-setting authority to determine and set exceptions and modifications in GAAP for private companies. The separate standards board would monitor the FASB's projects and provide input into the standards-setting process. In addition, the Blue-Ribbon Panel expressed its belief that the separate private company board should be able to initiate its own projects as deemed necessary.

The Report also stated that the ultimate authority to approve the exceptions and modifications should reside with the private company standards-setting board. That board would work with the FASB to ensure that when differences in GAAP for private companies are warranted, those differences are appropriately promulgated. The entirety of U.S. GAAP would continue to reside in the *FASB Accounting Standards Codification*[™], along with the exceptions and modifications for private companies.

Other Observations

As noted above, the Report recommended the creation of a differential framework to form the basis for the standards setter's decision-making process with regard to its proposed exceptions and modifications to GAAP for private companies. It is important to note that the Report did not advocate a separate, free-standing GAAP for private companies.

In addition to its primary recommendations on private company accounting standards, the Report indicated that the Blue-Ribbon Panel's members generally believed that the marketplace should be allowed to dictate whether private entities chose to follow what the panel termed, "private company GAAP" or "FASB GAAP." If the users of a private company's financial statements requested the financial statements to be prepared in accordance with FASB GAAP, the entity might be required to undertake a cost-benefit analysis. In addition,

some regulated private companies, such as privately held financial institutions (as discussed in further detail below) could be statutorily required to follow FASB GAAP. In any case, the standard setter would not determine whether private company GAAP or FASB GAAP was used to prepare the financial statements of nonpublic entities.

Basis for and Reaction to the Blue-Ribbon Panel's Recommendations

The deliberations of the Blue-Ribbon Panel and the reactions to its findings represented wide-ranging views. That diversity of views is sure to be considered by the FAF Trustee Working Group as it moves forward. With this in mind, the perceived pressures on smaller companies should be considered along with major arguments both for and against the formation of a separate private company standard setter and the need for differential accounting standards. To help narrow the discussion, particular attention is given below to the issues identified in the Report.

Pressures

Smaller companies and their auditors have been increasingly vocal about what they believe to be an escalation in overly burdensome and costly authoritative standards, and they do not see any relief forthcoming. The Report reiterated those concerns. In addition, the specter of convergence with International Financial Reporting Standards (IFRS) and its uncertain timeline looms ominously on the horizon.

The Blue-Ribbon Panel stated its belief that the standard-setting process is systemically flawed and has: “(a) an insufficient understanding of the needs of users of private company financial statements and (b) an insufficient weighing of the costs and benefits of GAAP for use in private company financial reporting.” The

Report listed the standards related to the following as lacking relevance to private companies: (a) variable interest entities; (b) uncertain tax positions; (c) fair value measurements; and (d) goodwill impairment.

The trend calls into question whether certain aspects of GAAP are “truly generally accepted.”

In addition, the Report cited the growing acceptance by issuers and users of review and audit reports with qualified opinions. The Report stated that the trend calls into question whether certain aspects of GAAP are “truly generally accepted.”

The Report also noted the seeming failure of the current standard-setting system to address the needs of smaller companies. With regard to the work of the PCFRC, the Report stated that “the FASB has not ... shown a willingness to consider carefully and approve, wherever appropriate, the possibility of measurement, recognition, or presentation differences.”

Concerns

The Blue-Ribbon Panel requested written input from concerned constituencies as part of its deliberations. Generally, the Report stated that:

Preparers and practitioners indicated that standard setting seems to be driven to a large degree by public company financial statement user needs and often tends to be more relevant to some of the users in that sector (especially equity investors) than it does to many users in the private company sector.

The Report cited the following specific concerns expressed by respondents:

- Private company financial statements often lack relevance to users.
- Standards have become increasingly complex.
- The pace of the standard-setting process has increased.
- Costs often exceed benefits.
- There has been an increase in qualified opinions and the use of other comprehensive basis of accounting (OCBOA) where possible.

The general theme of responses to the Blue-Ribbon Panel's outreach did not differ significantly from its own findings. Many respondents indicated the belief that an overall systemic deficiency in the standard-setting process was the cause of their concerns. Simply put, the Blue-Ribbon Panel stated in its Report that significant change was needed "to address the issues underlying the lack of relevance of a number of GAAP standards for many users of private company GAAP financial statements and the complexity of GAAP for private companies."

In addition to the concerns expressed by the Blue-Ribbon Panel, the November 2, 2009, letter from the PCFRC to the FAF (see the "Brief History of Differential Reporting Efforts" section above) cited the following events and trends in advocating for differential accounting standards for private companies:

- The International Accounting Standards Board (IASB)'s "International Financial Reporting Standard for Small and Medium-sized Entities" (IFRS for SMEs) (see the "IFRS for SMEs" section below);
- Efforts in other countries to address private company GAAP;
- A preference for differential standards for private company accounting shown in recent surveys of financial professionals; and

- The increase in complicated and expensive-to-implement accounting standards that appear to be driven primarily by public company investor and analyst needs.

An overall systemic deficiency in the standard-setting process was the cause of their concerns.

In reaction to the Blue-Ribbon Panel's Report, AICPA President Melancon said, "This issue has been discussed for 30-plus years and the time for FAF to act is now. While some changes have been made to the process to be more responsive to private companies, the panel concluded those were insufficient."

A Difference of Opinion

The Blue-Ribbon Panel's Report indicated that some members did not believe the creation of a new standard-setting board was warranted. The Report stated that those members felt the creation of a separate board was "... premature at this time because of the number of changes the FASB is currently implementing and the uncertainties about the future role of the FASB concerning public companies." One of the changes implemented by the FASB in 2010 was expanding its size from five to seven members.

Significantly, in January 2011, the FASB named Daryl E. Buck as one of its two new members. Mr. Buck was also a member of the Blue-Ribbon Panel and was Senior Vice President and Chief Financial Officer of Reasor's Holding Company, a private enterprise. He was also a founding member of the PCFRC, serving from 2007 to 2009.

The appointment of Mr. Buck to the FASB indirectly highlights another concern of those opposed to differential reporting. As noted, Mr. Buck's former company is a nonpublic entity — a company with \$400 million in annual sales.

Forbes.com reported November 3, 2010, on the 223 largest privately held firms in the United States. The top 100 companies on that list had most recent annual estimated revenues ranging from \$3.6 to \$109.8 billion, a mean average of over \$10 billion with a median of just under \$6 billion. In contrast, the 2010 Fortune 100 had average annual revenues of approximately \$61 billion with a median of approximately \$42 billion.² Those averages, while disparate, give credence to the notion that just because an enterprise is nonpublic, it is not necessarily small.

Even though the equity interests of the private companies may not be as widespread as those of most public companies, arguably the financial transactions of many nonpublic companies are no less complex and should not be exempt from the accounting and reporting requirements of their public counterparts. Opponents of differential reporting argue that the basic financial accounting and reporting needs of the users of many nonpublic company financial statements — whether financial institutions, venture capitalists, or other equity investors — are not necessarily different from those of public companies.

However, that is not to say that many smaller companies do not have simple ownership structures, possibly making them exempt from goodwill impairment testing and variable interest reporting concerns. In addition, many smaller companies do not engage in certain transactions (e.g., the use of derivatives and hedging), the accounting for which is seen as unnecessarily

complex by proponents of differential reporting. Finally, smaller private enterprises may have few fair value concerns since cash, trade receivables, and trade payables — although financial instruments — are exempt from fair value accounting requirements. Thus, current GAAP accounting and reporting requirements are, in many cases, moot.

Just because an enterprise is nonpublic, it is not necessarily small.

Finally, the Report noted the following objection to its proposed model:

Depending on the extent of exceptions and modifications made by the new board, the result could be substantially different accounting standards for private companies resulting in a lack of comparability, and additional costs and strain to some in the U.S. financial reporting chain. Once a separate board is given authority over private company standard setting, there may be limited ability to stop any such divergence.

NASBA Chairman Atkinson indicated he shared "... concerns regarding the relevance, complexity, and cost of today's accounting standards." However, he added "... a separate accounting standard-setting body for private companies would lead to differential standards and result in other unintended consequences."

Other Differential Reporting and Standard-Setting Issues

The terms, "nonpublic," "private," and "small" are used somewhat loosely and interchangeably

² HCA Holdings, Inc., with revenue of \$30 billion, became a public entity in 2010 and was included in both lists.

to describe entities that are nonissuers in the sense that they do not have securities trading in a public market (or are not otherwise regulated by or required to report to the U.S. Securities and Exchange Commission or its equivalent, if outside the United States). This circumstance poses an obvious — and seemingly overlooked — question. Does the need for differential reporting standards occur at the public/nonpublic demarcation line or at some other threshold?

IFRS for SMEs

Perhaps the July 2009 guidance presented in the IFRS for SMEs can be helpful in addressing that question. According to the IASB, small and medium-sized entities are entities that: (a) publish general purpose financial statements for external users; and (b) do *not* have public accountability. External users include equity holders who are not involved in managing the business, creditors, and credit rating agencies.

With regard to public accountability, the IASB indicates that an entity has public accountability if either of the following is true:

- Its debt or equity instruments are traded in a public market, or it is in the process of issuing such instruments for trading in a public market.
- It holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses, such as is typically the case for banks, credit unions, insurance companies, mutual funds, investment banks, and securities brokers and dealers.

In a similar manner, the PCFRC considers a private company one that is not a financial institution and does not have U.S. Securities and Exchange Commission (SEC) reporting requirements. However, we understand that the

Blue-Ribbon Panel quickly dismissed the use of IFRS for SMEs as an alternative model in the United States.

SEC Considerations

On August 1, 2008, the SEC released the “Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission.” The Advisory Committee was formed to examine the U.S. financial reporting system to develop recommendations for increasing usefulness and reducing complexity of financial information. The Advisory Committee limited its deliberations to matters related to public companies. However, the Advisory Committee Report indicated that “the principles underlying [its] recommendations to improve the standards-setting process would be relevant to any accounting standards-setter.”

The Advisory Committee limited its deliberations to matters related to public companies.

Among the 25 recommendations presented was the need for “the presumption that formally promulgated alternative accounting policies should not exist.” Also, the Advisory Committee Report recommended that new projects undertaken by the FASB minimize the use of exceptions. Finally, the Advisory Committee Report recommended that the FASB’s projects not create “additional competing models, except in rare circumstances.”

In addition, the Advisory Committee Report indicated the following:

To the extent practicable, going forward, there should be a single standards-setter for all authoritative accounting standards and interpretive implementation guidance that are applicable to a particular set of accounting standards, such as U.S. GAAP

There should be a single standards-setter for all authoritative accounting standards.

Although not directly on point to the current discussion, the SEC has made its general views on changes to financial reporting and standards setting known through the Advisory Committee Report's recommendations.

Separately, based on historical practice, the SEC would not accept, in registrant filings, a different U.S. GAAP — a clear consideration if use of the aforementioned private company GAAP becomes reality. That practice means a company contemplating an initial public offering would have to “recharacterize” all of its financial statements presented using FASB GAAP before the SEC would allow the company to sell its securities to the public. This issue could also be a concern if an existing public company entered into an acquisition of a company that used private company GAAP. Specifically, when an existing public company acquires an entity that is significant to it (as defined), financial statements of the company being acquired are necessary. Obviously, this concern is not relevant if a company never expects to sell securities to the public or to be acquired by a public company.

Other Uncertainties

The educational implications of differential accounting and reporting standards could also

reasonably be the subject of debate. Complex and rapidly evolving standards certainly present challenges academically and in practice. Also, IFRS is being added to both the realm of academia and the content of the CPA exam. The introduction of separate, private company GAAP may significantly affect accounting educational and certification programs in the United States.

The Report of the Blue-Ribbon Panel stated that one preparer felt “that the biggest challenge was not the complexity of the standards themselves but rather having to provide the necessary education for private sector accountants.” Clearly, the Blue-Ribbon Panel’s “GAAP by exception” model, as it has been termed by some, would reduce the knowledge base required of private company financial statement preparers.

The Report also stated that small CPA firms “believed that the complexity of the standards are exposing firms to additional liability and risk because they do not have the in-house capabilities and time to stay abreast of the changing standards.” However, that assertion begs the question of whether those firms would somehow limit their practices to small private entities, as ultimately defined. In addition, would the structure of the Codification be made such that differentially modified and excluded guidance could be omitted for use in audits of private companies?

Moving Beyond the Report of the Blue-Ribbon Panel

With the issuance of its “Report to the Board of Trustees of the Financial Accounting Foundation,” the Blue-Ribbon Panel effectively concluded its work. According to the FAF, the establishment of the Trustee Working Group is the next phase of the FAF’s review of the adequacy and effectiveness of the FASB’s efforts in setting standards for the private company

and non-profit sectors in the United States. FAF President Polley said:

The FAF applauds the [Blue-Ribbon Panel's] efforts ... and will thoughtfully and thoroughly consider the issues raised ... as well as the recommended solutions. The [Report], along with further analysis and constituent input, will be valuable in reaching sound decisions that improve standard setting and financial reporting for private companies.

The Trustee Working Group will conduct outreach to stakeholders in various ways.

The FAF has indicated that part of the process of seeking further constituent input would include exposing for public comment any potential significant changes to the standard-setting process and structure. With the announcement of the formation of the Working Group, the Trustees of the FAF indicated that the Trustee Working Group will conduct outreach to stakeholders in various ways.

According to the FAF, that outreach will include roundtable meetings, surveys, and meetings with advisory and constituent groups. As part of their consideration, the Trustees will also seek additional input on suggested improvements to standard setting for private companies, including the solutions recommended by the Blue-Ribbon Panel. John J. Brennan, FAF Chairman, said:

The FASB has an enormous responsibility in setting accounting standards for all nongovernmental entities in this country. The FAF Trustees' initiative to review the

unique needs and challenges of non-profit entities and private companies is part of our commitment to ensuring that the processes and resources are in place to meet the financial reporting needs of all providers of capital, preparers of financial statements, auditors, regulators, and others. We look forward to sharing our findings with all of the FASB's constituents.

Finally, Leslie F. Seidman, Chairman of the FASB, was interviewed by BNA on December 17, 2010, before the final Report of the Blue-Ribbon Panel was issued, but after it became evident that the panel would propose a separate board to address the accounting for private companies. Ms. Seidman stated:

My goal is to try and restore their confidence in our ability to address their concerns [of private companies and the users of their financial statements] more effectively. In addition to the steps that we've taken in recent years and months to do that — first by establishing the [PCFRC], by adding senior staff, and now more project managers that are specifically assigned to all of our major projects, with a particular focus on the concerns raised by private companies — we've also been conducting roundtables focused on private company concerns, as well as on every major project, making sure we have a focused discussion with people on the concerns raised by private companies about those particular projects.

We're hoping to demonstrate through our actions that we want to be responsive to the concerns raised by private companies and do a better job evaluating how, in each and every accounting standard, we can provide the most useful information to the users of private company financial statements at a reasonable cost.

... [W]hat we have done is assigned a staff member to develop a white paper to address these issues, which we hope to discuss with our [PCFRC] at the next meeting

... [I]t is not clear how others will feel about this issue, and the [FAF] is really the entity that will determine what action is necessary. But we, again, are taking steps right now to try and be more responsive to these issues. I mentioned the white paper. Another step that we've taken is to have board members attend the meetings of the PCFRC, so that we hear first-hand their views on the live

projects, as they're being developed. And this, in retrospect, this is something I think we should have implemented from the start. But it's never too late to improve. So we're taking the steps now that we can foresee that we think would improve our ability to address their concerns more effectively, without any need for further development of the Blue-Ribbon Panel.

The entire BNA interview with Ms. Seidman, conducted by Steve Burkholder, is available on *Accounting Research Manager* at: <http://www.accountingresearchmanager.com/wk/rm.nsf?Open&M=vwUID/2EFDC9B7>.

To discover how Accounting Research Manager® can help you stay in compliance with recently issued standards and developments, [contact your CCH Account Representative](#).

"A Closer Look" was prepared by the Chicago-based staff of CCH's Accounting Research Manager. It is published with the understanding that the publisher is not engaged in rendering legal, accounting, tax, or other professional services. If legal, accounting, tax, or other professional assistance is required, the services of a competent professional should be sought.