

**PRIVATE COMPANY FINANCIAL REPORTING**  
**Discussion Paper – May 2004**

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## SECTION I – OVERVIEW OF TOPIC

This Discussion Paper is intended to help ensure an informed dialogue on the question of whether or not general purpose financial statements of private (or privately-held), for-profit entities, prepared in accordance with generally accepted accounting principles (GAAP), meet the needs of all constituents of that reporting. A related question is whether or not the cost of providing all that is required in GAAP financial statements is justified by the related benefits to private company constituents. As a constituent of private company financial reporting, you have a vested interest in sharing your views on these fundamental questions.

### SCOPE AND DEFINITION

“Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions – for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities.”<sup>1</sup>

The standards for financial reporting are known as GAAP and are established by the Financial Accounting Standards Board (FASB). Financial reporting is driven by the general purpose of meeting the needs of external stakeholders that lack the ability to prescribe the information they need and, therefore, must rely on information that companies provide. In addition, general purpose financial reporting is directed toward the common interests of various potential users of that reporting for making investment and credit decisions.

In most cases, external users of private company financial reporting probably have the ability to obtain the financial information they require for making capital allocation decisions directly from private companies. Still, for some reasons, many private companies prepare financial statements in accordance with GAAP (which, as mentioned, are focused on general purpose needs). This Discussion Paper and research effort are focused on general purpose GAAP financial reporting by private companies.

Though GAAP financial reporting is geared primarily towards external users, management of private companies also use that reporting. Many private company financial statements include an independent public accountant report issued as the result of an audit, review, or compilation (including full or no/selected disclosures).

The Board of Directors of the American Institute of Certified Public Accountants (AICPA) has formed a special task force to conduct research to determine if general purpose financial statements of private, for-profit entities, prepared in accordance with GAAP, meet the needs of all constituents of that reporting. This research is confined to what GAAP financial statements can convey. Therefore, a study of the broader

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<sup>1</sup> FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, paragraph 9.

information needs (such as disclosure of non-financial performance indicators) of constituents of private company financial reporting is beyond the scope of this effort.

For the purposes of this research, constituents of private company financial reporting include external stakeholders (for example, lenders, equity investors, governmental entities, and sureties), owners and management, and public accounting practitioners.

The task force decided that the availability of this Discussion Paper would contain helpful information for constituents contemplating this topic.

## HISTORY

Over the past three decades, a number of organizations have studied this topic. In the U.S., the AICPA and the FASB have studied the topic but have not done so in-depth in recent years. Internationally, a number of national standard-setters have studied the topic recently and implemented varying degrees of changes to their standards or standard-setting structure. For more historical information, please visit [http://www.aicpa.org/news/2004/2004\\_0308\\_privco\\_finreprtng.htm](http://www.aicpa.org/news/2004/2004_0308_privco_finreprtng.htm).

## CURRENT ENVIRONMENT

Private companies are a significant element of the U.S. economy. “Five and one-half million businesses employ people other than the owners.”<sup>2</sup> “Four of five employing businesses have fewer than 20 people working in them.”<sup>3</sup> “17,000 of the nation’s 4.9 million corporations are registered with the SEC.”<sup>4</sup> “Small and young companies create two thirds of the net new jobs in our economy, and they employ half of all private-sector workers.”<sup>5</sup> Private businesses are a large part of the U.S. economy, and many of those businesses seek and receive capital from external stakeholders.

The nature of business and business transactions is more sophisticated than ever. Both public and private companies implement complex business strategies, form complex ownership structures, use complex risk management strategies, and use technology in their products and services.

By design, a standard-setter (such as FASB) focuses on general purpose financial reporting that is used by the capital markets for making investing and lending decisions. As new types of transactions or events are created or as information needs change, the standard-setter is asked to react to situations in which the accounting is unclear based on current standards or where current standards can be improved. Therefore, the body of standards continues to expand and the standards’ complexity matches the transactions they address.

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<sup>2</sup> NFIB Small Business Policy Guide, page 17.

<sup>3</sup> NFIB Small Business Policy Guide, page 17.

<sup>4</sup> Accounting Today, October 6-19, 2003, page 3.

<sup>5</sup> See <http://www.whitehouse.gov/infocus/smallbusiness/agenda.html>

In response to financial reporting scandals of public companies, Congress passed, and the President signed, the Sarbanes-Oxley Act of 2002 (the Act), which imposes new requirements for public companies and their auditors. Among those requirements: increased responsibility for boards of directors and audit committees; certification by CFOs and CEOs of the accuracy of financial statements; and additional disclosures in the Management Discussion and Analysis section of reports filed with the Securities and Exchange Commission (SEC).

The Act also formalizes the SEC's reliance on FASB as the accounting standard-setter for public companies, and it provides for FASB's funding via fees assessed on public companies based on market capitalization. The SEC has stated that it will exercise a vigorous oversight of FASB's agenda. Both the SEC and FASB primarily focus on general purpose financial reporting that provides information to external users of that information. Additionally, both the SEC and FASB have identified the following as priorities of standard setting:

- More timely guidance
- Movement towards convergence to a high quality set of standards used both domestically and internationally
- Movement towards more principle-based (or objective-based) standards and standards that are anchored in an asset/liability approach rather than a revenue/expense approach
- Movement towards fair value measurements where it is determined that such measurements provide for relevant financial information.

FASB also is given explicit (via the AICPA's code of conduct) and implicit (via general acceptance) authority to set standards for private companies.

### MEETING THE NEEDS

One may think of the broad elements of GAAP financial reporting as relating to:

- Recognition of assets, liabilities, equity, revenue and gains, expenses and losses, and other comprehensive income – for example, if and when to report a liability
- Measurement - for example, historical cost, fair value, or lower of cost or market, and the measurement methodology used
- Presentation - for example, balance sheet display
- Disclosure - for example, notes to financial statements.

In most cases, GAAP currently does not provide for different recognition and measurement principles based on whether an entity is public or private; however, GAAP sometimes provides for differences in presentation, disclosure, transition methods, and effective implementation dates. Thoughts on whether or not private company GAAP financial statements meet the needs of constituents of that reporting might depend on consideration of one, some, or all of the broad elements listed above.

## COST/BENEFIT

There are costs related to providing and not providing certain information in general purpose financial statements. An important consideration is whether the cost/benefit relationship for private company constituents is reasonable. This may be impossible to quantify but many constituents may have views on the cost/benefit relationship.

## REQUEST FOR YOUR PARTICIPATION

Constituents of private company financial reporting have a vested interest in determining if general purpose financial statements of private, for-profit entities, prepared in accordance with GAAP, meet the needs of all constituents of that reporting. To stimulate thoughts and discussion, Section II of this Discussion Paper includes some overall viewpoints on this topic. In addition, Section III includes some viewpoints on certain GAAP standards.

In the near future, all constituents of private company financial reporting will have an opportunity to share their views via surveys. This Discussion Paper has been issued in advance of the surveys so that constituents may begin forming their thoughts on the topic.

## **SECTION II - VIEWS EXPRESSED ON SOME BROAD ASPECTS OF PRIVATE COMPANY FINANCIAL REPORTING**

### **Relevance**

Some believe that private company financial statements prepared in accordance with GAAP provide very useful information related to the existence of assets, completeness of recorded liabilities, their values, performance, and the rights and obligations of companies. They believe that, regardless if one disagrees with a particular standard, the overall framework is as useful to constituents of private company reporting as it is to those of public company reporting. They also believe that similar transactions entered into by private and public companies should have similar recognition and measurement requirements and not change based on whether a company is private or public. Many who hold these views appreciate the need to consider different disclosures for private companies on a topical basis.

Others believe that users of public and private entities' financial statements have different objectives and needs. They believe that public company financial statement use primarily focuses on valuation whereas private company financial statement use primarily focuses on stewardship. This view states that as the complexity of business and its financial statement needs continue to grow, the paths needed for public and private GAAP will diverge. They note that the SEC and FASB are committed to more fair value reporting by public companies in place of historical cost measurement. Given this commitment, they believe that the underlying accounting and related reporting for public and private companies can no longer remain the same. Therefore, they believe that private company GAAP financial reporting should provide for recognition and measurement differences as well as different disclosures on a topical basis.

### **Cost**

Some believe that the costs of preparing GAAP financial statements of private companies outweigh the related benefits to all of the constituents of that reporting. They believe that many private companies are frustrated because the companies themselves and their internal and external stakeholders do not use all of the GAAP information required in financial statements. They also believe that many companies and practitioners are overwhelmed by the complexity of requirements that either (a) require topical expert resources in order to understand or report on that complexity, or (b) are not applicable or useful in meeting the needs of users of private company financial reporting.

Others believe that the cost of preparing GAAP financial statements is but one cost to consider. They believe that one should consider costs that would be created if there were different financial reporting requirements for public and private companies: For example, costs related to education, quality control systems, and training of personnel for

stakeholders who deal with both public and private companies – such stakeholders may include auditors and external users. They also believe that private companies would experience an increased cost of capital if financial statements of public and private companies differ significantly because the capital markets will view public company financials as providing more relevant information.

### **Alternatives**

Some do not understand why constituents of private company financial reporting raise broad-based issues related to GAAP. They observe that there are alternatives to GAAP financial reporting in the U.S. that are not available in many other countries. Companies may choose to report financial information on an other comprehensive basis of accounting (OCBOA), such as on an income tax basis or cash basis of accounting, or may use GAAP but with noted GAAP departures. Alternatively, they observe that private companies may not need a formal reporting structure if their users can get whatever information they need from the companies. They believe that if these alternatives to preparing GAAP financial statements are not accepted by lenders and investors, the point is proven that GAAP is useful and perhaps superior to all other forms of related reporting.

Others acknowledge the existing alternatives to GAAP financial reporting. However, they believe that the alternatives are perceived by many as “something lesser” or inferior. They believe that this perception is institutionalized in the minds of many constituents because of the notion of one GAAP for all companies. In addition, they observe that various industry regulators require one GAAP for all companies. They also believe that the discussion should not focus on superiority or inferiority; rather the discussion should focus on developing GAAP that is more useful and cost effective to constituents of private company financial reporting. They seek what some foreign national standard-setters have done – recognize the different needs of constituents of private company reporting via different financial reporting requirements, which could fall under the umbrella of a GAAP for private companies that is as reliable and accepted as current GAAP is for public companies.

## **SECTION III - VIEWS EXPRESSED ON SOME GAAP STANDARDS**

### **Standards Topic No. 1**

#### ***FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity***

##### ***Background***

In May 2003, FASB issued Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or asset in some cases). Before this Statement, many of those instruments were classified as equity.

##### ***Views***

Some believe that this standard is a prime example of a standard that was unnecessary for private companies and their lenders. Many smaller, private companies have buy-out agreements that require the redemption of ownership interests at the death or retirement of the owners at the then fair value of those interests. Because these arrangements under the Statement must be reported as liabilities, they note that implementation often results in negative equity in the balance sheet of these companies when the business owners know that the company has positive equity in the event that they sell the company, for example. Also, they note that many buy-out arrangements are funded by life insurance purchased by companies for that reason and that companies cannot recognize that offset in their financial statements.

Further, they say that reporting these transactions as liabilities runs counter to how private company owners and managers think of the results of their business. They also say that lenders understand the nature of these arrangements and were quite content to agree to debt covenants with balance sheets that reported many mandatorily redeemable agreements as equity. In summary, they conclude that this standard was a “fix” to private company balance sheets where no fix was needed.

Others say that a cure was needed for the diversity in practice that existed before this Statement was issued. They believe that one cannot deny the logic of reporting mandatorily redeemable financial instruments as liabilities. For example, buy-out agreements that require redemption of ownership interests at the death or retirement of

owners result in a present obligation to sacrifice assets upon death or retirement – the very definition of a liability, as currently defined.

They also believe that the impact of these transactions in the balance sheet, even if it results in negative equity, is a fair portrayal of a private company's assets minus liabilities. Some appreciate how an owner of a company may argue that such reporting is nonsensical if he/she could sell the company for an overall gain but they caution that owners' equity is not intended to represent the fair value of owners' interests.

## Standards Topic No. 2

### Fair Value Accounting - General

#### *Background*

The requirement to measure some items at fair value has been in the accounting literature for a number of years. However, in recent years, the number of accounting standards requiring fair value measurements and disclosures has increased significantly, and the trend is expected to continue. Specifically, fair value measurement is a prominent component of the following accounting standards:

- FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*
- FASB Statement No. 123, *Accounting for Stock-Based Compensation*
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
- FASB Statement No. 141, *Business Combinations*
- FASB Statement No. 142, *Goodwill and Other Intangible Assets*
- FASB Statement No. 143, *Accounting for Asset Retirement Obligations*
- FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*
- FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*
- FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*
- FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*

#### *Views*

Some believe that fair value accounting often is relevant to users of private company financial statements. Specifically, they say that fair value is the most relevant measure for financial instruments, derivatives, and acquisition accounting. They also note that there is no intention of requiring fair value of all assets and liabilities, but rather only in those circumstances in which fair value is deemed to be most relevant to users.

They appreciate concerns about a lack of guidance on fair value measurements but point to a current FASB project on fair value measurement that is intended to help alleviate those concerns. In addition, they note that similar concerns were raised when FASB Statement No. 87 on pensions was issued but companies and auditors learned to work with actuarial expertise to help provide users with better information on pensions.

Further, they observe that a side benefit of fair value reporting has been to help instill discipline in companies' risk management practices.

Others are very concerned about the trend towards more fair value accounting in private company financial statements, especially in light of the belief that lenders, investors, and some industry regulators do not use certain fair value information. For instance, they cite goodwill as a prime example. They also note that private companies and auditors face increased complexity in determining impairment of goodwill and certain other long-lived assets because they are no longer amortized.

They also believe that fair value is not reliably estimable in many cases; that is, observable market prices often do not exist for private companies and many of their assets. Coupled with their belief that fair value often is not relevant to users of private company financial statements, they believe that the cost of preparing that information exceeds the related benefits, especially when outside valuation experts must be hired to help determine fair value. They also note that valuation experts using similar valuation techniques often arrive at different fair value determinations.

## **Standards Topic No. 3**

### **FASB Interpretation No. 46, *Consolidation of Variable Interest Entities***

#### ***Background***

In January 2003, FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46) to clarify circumstances where a reporting entity "controls" another entity in which that control is not readily-apparent through ownership interests. Many variable interest entities (VIE) had commonly been referred to as special-purpose entities or off-balance sheet structures. In December 2003, FASB issued a revision to FIN 46 to clarify some of the provisions in the "original" document. The objective of FIN 46 is not to restrict the use of VIEs but to improve financial reporting by enterprises involved with VIEs.

#### ***Views***

Some people, while acknowledging the need for a standard on VIEs for public companies, believe they do not need FIN 46 to help them determine control with respect to privately-held companies. They note that they generally have not experienced the problems with VIEs that have plagued public companies, and they note that the accounting abuses were abuses by public companies. They say that in many cases the owners' personal equity is at complete risk in private companies.

Further, they believe that FIN 46 is very complex, and for smaller, privately-held companies, the cost of implementing it will exceed the benefits to users of the financial statements. They believe that lenders are more interested in the separate financial statements of related companies than in consolidated financial statements. They also believe that lenders prefer combined financial statements for privately-held entities under common control instead of consolidated financial statements and that the concept of combined financial statements is easier to understand than consolidation under FIN 46. Furthermore, they believe the combined financial statements more clearly present the ownership and control structure of privately-held entities under common control.

Others believe that the well-publicized accounting scandals of recent years demonstrated a need for guidance on consolidation when voting interests are not effective in identifying whether an entity is controlled by another party. They believe the basis for conclusions in FIN 46 is right on point where it states:

Transactions involving variable interest entities have become increasingly common, and the existing accounting literature is fragmented and incomplete. Some enterprises have entered into arrangements using

variable interest entities that appear to be designed to avoid reporting assets and liabilities for which they are responsible, to delay reporting losses that have already been incurred, or to report gains that are illusory.

Further, they believe users of financial statements will receive better information from companies because the accounting for similar activities, regardless of whether or not they are conducted through VIEs, will be similar. In addition, they note that users will receive more complete information as to the resources, obligations, risks, and opportunities of the consolidated entity. They also note that currently many situations with related companies under common control are not presented in combined financial statements nor are there meaningful disclosures about the non-combined companies.

## **Standards Topic No. 4**

Following is a list of some other financial reporting topics that one may wish to consider on the general questions of whether or not (1) general purpose financial statements of private, for-profit entities, prepared in accordance with GAAP, meet the needs of all constituents of that reporting and (2) the cost of providing all that is required in GAAP financial statements is justified by the related benefits to private company constituents.

Cash flow statement (for example, direct vs. indirect methods)

Comprehensive income measurement (for example, items excluded from the income statement)

Deferred income taxes (for example, the usefulness of reporting deferred tax assets and liabilities)

Guarantees (for example, the usefulness of recognizing and measuring the fair value of certain guarantees)

Intangibles (for example, goodwill accounting)

Leases (for example, capitalized vs. operating)

Post retirement and retirement plans (for example, pensions)

Revenue recognition (current FASB project – direction is an asset/liability approach rather than the “traditional” income statement approach)

Share-based payments (current FASB exposure draft allows private companies to use the intrinsic value method instead of the fair value method)