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Setting private company accounting standards

Recent recommendations miss the mark

Highlights

- An advisory panel recommends the creation of a second US accounting standard-setting board. The second board would have full authority to make exceptions to accounting standards for use by private companies.
- This recommendation would reduce the quality of information provided to users and create undue cost and complexity.
- We support a single US standard-setting board and a more measured approach to changes in the standard-setting process.

The private company accounting debate continues

- Private companies have voiced concerns about the complexity of accounting standards. They are not alone. Concerns over the cost and difficulty of applying accounting standards, and the relevance of the resulting financial information, are shared by public companies too. Even so, a Blue Ribbon Panel (the Panel) was formed to study enhancements to the accounting standard-setting process for US private companies.

- The Panel recently released a report calling for a new standard-setting board (a second board) to be responsible for setting accounting standards for private companies. The second board would have full authority to make exceptions and modifications to current and future accounting standards established by the Financial Accounting Standards Board (FASB). Despite stated intentions not to create a separate set of standards for private companies, we believe the Panel's recommendation to form a second board will do exactly that.

- Our alternative approach is less radical and more sensitive to the current dynamic standard-setting environment. Importantly, our approach focuses on quality financial reporting and would limit unnecessary differences, reduce standard-setting costs, and reduce the complexity of financial reporting for all companies, public and private. It also supports greater private company input into the standard-setting process. Our approach complements recent changes in the FASB's composition and processes by creating additional enhancements within the existing structure of a single standard-setting board.

Our concerns with the Panel's recommendation

The Panel obtained only anecdotal information on the needs of the broad population of users of private company financial statements.

Quality financial information for users is the critical cornerstone.

The Blue Ribbon Panel

In December 2009, the Financial Accounting Foundation (the Foundation), the American Institute of Certified Public Accountants (the Institute) and the National Association of State Boards of Accountancy sponsored the Panel to study enhancements to the accounting standard-setting process for US private companies.

In 2010, the Panel obtained input from constituents in the financial reporting chain. In January 2011, the Panel issued its report to the Foundation Trustees.

The Panel's recommendations

The Panel recommends the creation of a second board under the oversight of the Foundation. The second board would work closely with the FASB; however, it would have final authority over private company standards. The Panel envisions the second board will make exceptions and modifications to FASB accounting standards for use by private companies. The Panel also recommends that a framework be established to guide differences in private company standards, and that certain other actions be taken to increase private company representation in standard-setting. Some Panel members disagreed with establishing a second board. They prefer to first determine if recent changes in FASB staffing and processes can adequately address concerns.

Quality as the cornerstone

Our profession has unique responsibilities in facilitating capital formation and the effective operation of the capital markets. Those responsibilities include advocating for high-quality, operational, cost-effective, and transparent financial reporting standards that meet investor and other user needs. We take our responsibilities very seriously. And as one of the largest auditors of private companies in the world, our responsibilities extend to accounting standards for both public and private companies. Some may form their views based primarily on costs of preparation. To us, although cost is an important consideration, quality is the critical cornerstone in determining the financial information that should be reported to users. This is the lens through which we evaluated the Panel's report.

Our concerns

The Panel's analysis did not demonstrate that standards set by a second board would better meet the needs of users of private company financial statements. Without clear evidence that user needs are best met by a second board, the Panel's basis for this fundamental change relied on arguments about reduced costs.

The limited scope of the Panel's focus on private companies does not do justice to the broader issue. Public companies share the same cost, complexity, and relevance concerns as private companies. Simplification and increased cost effectiveness of accounting standards for all companies, where possible, is a more effective path forward.

Inevitably, creating a second board will lead to different standards. A board created for a particular purpose will naturally measure its success by how much it accomplishes. This outcome is concerning, as we believe the economics of transactions should result in similar accounting for all companies, public and private. Although we can envision a few instances where separate recognition and measurement standards for private companies can be justified, we believe these situations would be infrequent.

The Panel's recommendation also does not give sufficient weight to the current standard-setting environment. The broader movement to achieve convergence between US and international accounting standards should not be ignored.

Lastly, the Panel's recommendation does not adequately address certain operational issues, including the complexity of maintaining separate standards and funding a second board's operations.

Our principles and alternative approach

Changes to the current US standard-setting structure should be measured. The FASB should remain as the single standard-setting board for non-governmental entities.

The framework for our approach

To frame the thinking for our alternative approach, we developed the following set of guiding principles.

- Potential modifications to standards should be evaluated through a user's lens.
- Changes to the standard-setting process and modifications to reduce complexity in accounting standards should be considered for all companies, public and private.
- Recognition and measurement differences for private companies should be justified based on the quality and relevance of the reporting.
- More input from private company constituents should be obtained as the standard-setting process evolves.

By following these principles, the resulting recommendations become more measured and evolutionary, and better address the underlying fundamental issues.

Our recommendations on process

In our view, a sufficiently comprehensive study of any differing information needs of public versus private company investors is needed before dramatic changes are instituted. This study would provide the basis for creating the framework recommended by the Panel to guide standard setters when evaluating whether differences for private companies are warranted. Use of this framework, with which we agree, will promote clear reasoning for any differences for private companies. So, for example, if private company investor needs are substantially being met, then it follows that changes to existing standards should be considered only when the quality of reporting remains high and the cost and complexity of applying standards can be reduced.

This approach will generally reduce differences in recognition and measurement, which is in the best interest of investors. The economics of transactions should not be reported differently based on the public or private nature of a company's ownership. Alternatively, differences in presentation and disclosure may be more frequent.

Without consistent application of a robust framework to guide this evaluation, very different standards would likely be created. Two significantly different sets of standards would increase complexity and be costly and disruptive for the financial reporting system. Investors would need to make adjustments to their investment analyses to accommodate differences. Systemic changes would be needed in our educational system to teach both sets of standards. Greater barriers would also be created for private companies when entering the public capital markets.

Our recommendations on structure

At the present time, we believe the FASB should remain the single standard setter in the US for non-governmental entities. Having only one US board will reduce the cost and complexity of the standard setting process and provide greater flexibility down the road as a decision on incorporating international standards into the US financial system evolves.

Within the context of a single-board structure, other enhancements should be made to incorporate greater private company input into the standard-setting process. For example, we recommend that the Private Company Financial Reporting Committee (the Private Company Committee) of the FASB be reconstituted and its responsibilities realigned to enhance the value of its input. Further, we suggest that the FASB expand the membership of its Emerging Issues Task Force to include a voting member who is recommended for appointment by the Private Company Committee.

These collective changes, in connection with recent FASB staffing and process enhancements and the appointment of a FASB member with private company experience, would increase the level of substantive private company participation in the standard-setting process in a measured yet effective manner.

Questions and answers

Q: In making its recommendations, how did the Panel consider the diverse needs of the wide population of users of private company financial statements?

A: In our view, the significant standard setting change proposed (a second board) requires clear evidence that the change will increase the quality and relevancy of the resulting standards. We believe the Panel could have done more to obtain this supporting evidence. For example, a comprehensive study could have been done of the information needs of the diverse population of private company financial information users. Rather than conducting such a study, the Panel seemed to rely more on anecdotal feedback from users which interestingly, was that generally their needs are being met currently. In summary, before making such a recommendation, more should have been done to demonstrate that standards set by the second board would improve the quality of reporting, increase relevance, and better meet the needs of users of private company financial statements.

Q: How should preparer costs be considered in standard setting?

A: Good standard setting requires finding the right balance between quality, relevance, and cost. The goal is to develop high-quality standards that provide benefits to users that outweigh the costs to preparers. Standards with lesser incremental value to users, that are costly to preparers, should be changed. At the same time, standards that provide substantial information value to users should be maintained, even if they are sometimes costly to prepare. Finding the right balance is key.

Q: You recommend that the Private Company Committee should be reconstituted and have different responsibilities. What specific changes are you recommending?

A: Currently, members of the Private Company Committee are selected by its Chairman and approved by the Institute and the FASB. To raise its profile, we believe the Private Company Committee should become an arm of the Foundation and that its members should be appointed by the Foundation in a process that mirrors the appointment of members of the FASB's Financial Accounting Standards Advisory Council (the Advisory Council). The process, procedures, and frequency of meetings should also mirror those of the Advisory Council. Once the framework recommended by the Panel is in place, the Private Company Committee and the FASB would share a common understanding, which should assist the Private Company Committee in advising when differences are warranted for private companies. This alignment would also help the Private Company Committee to provide more relevant and beneficial guidance to the FASB. For example, a responsibility of the Private Company Committee would be to use the framework to analyze topics currently being considered by the FASB for possible areas of differential financial reporting for private companies and to recommend alternatives.

Contact Information

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