

# point of *view*

## Financial reporting for private companies

### Are separate accounting standards the answer?

#### Highlights

- A single set of high-quality accounting standards for general purpose use by public and private companies should be followed.
- This single set of standards will best reflect the economics of transactions for all companies while reducing the duplicative costs that would result from multiple sets.
- To address concerns expressed over complexity and costs of preparation, financial reporting for all companies, public and private, should be streamlined.
- When the information in general purpose financial statements exceeds the needs of certain users of private company financial statements, alternative forms of reporting designed for limited purposes could be the solution.

#### What's the answer for private companies?

- U.S. accounting standards have become increasingly complex. Many preparers, public and private, struggle to stay current with the latest interpretations of how the standards should be applied and the volume of newly-issued standards.
- There is a disconnect between the extensive information contained in general purpose financial statements prepared in accordance with generally accepted accounting principles (general purpose financial statements) and the narrower information needs of certain users of private company financial statements.
- General purpose financial statements are designed to assist a broad base of users in their decision making. The distribution of private company financial statements is often limited and, in many cases, private company financial statement users have an ability to request information that public company investors do not.
- Users often request general purpose financial statements because of their comfort with the standards. However, limited-distribution, special-purpose reporting that better fits the needs of users of private company financial statements is possible in many situations. Private companies could work with the users of their financial statements to agree upon alternative forms of reporting. This effort will be worthwhile if it results in meeting the user's needs while reducing preparation costs.
- Measures should also be taken to obtain greater private company input into the accounting standard-setting process.

# Private company investors often have needs that can be met through different means

**There is a disconnect between the extensive information contained in general purpose financial statements and the narrower information needs of certain users of private company financial statements.**

For decades, the financial reporting community has debated whether U.S. private and public companies should follow the same accounting and reporting standards. In December 2009, a "Blue Ribbon Panel" (the "Panel") was formed to again address this issue. The group consists of preparers, users and auditors of primarily small- and medium-sized private companies. The Panel is deliberating several alternatives to the current standard-setting structure, including the potential creation of a separate standard setting body and separate standards for private companies. It expects to make a recommendation to the Financial Accounting Foundation (the "Foundation"), the overseer of the Financial Accounting Standards Board (the "Board"), at the beginning of 2011.

We have listened closely as the Panel has discussed the needs of the users of private company financial statements and concerns expressed by preparers and auditors. From that discussion, it seems clear that users value general purpose financial statements. Some users may not understand the intricacies of certain standards, but nonetheless seem to find comfort that those standards are being followed.

However, in a growing number of cases noted by the Panel, certain users are willing to accept qualified opinions on audited financial statements, allowing deviations from promulgated accounting standards in some areas as long as the financial statements continue to meet the user's needs. Panel members indicated that this sometimes occurs at the request of private companies that find particular standards costly and difficult to apply, or when the financial reporting that results from applying the particular standards is judged not to be relevant or necessary for that specific user.

## ***The case for separate standards***

U.S. accounting standards have become increasingly complex over the past few decades, to the point where many

preparers, public and private, struggle to stay current with the latest interpretations of how the standards should be applied and the volume of newly-issued standards.

Some believe that U.S. standard-setting has more recently focused on the needs of financial analysts following public companies without duly considering the needs of private company financial statement users. This has resulted in some concluding that for many private companies, the costs to comply with these standards often exceeds the benefits to the users of those financial statements. For example, many owners of private companies and users of their financial statements do not favor the use of fair value accounting, citing historical cost as the more relevant basis on which their owners manage the business and evaluate performance.

Some also argue that certain users of private company financial statements are confused by the more complex accounting and find significant aspects of that reporting not to be relevant to their information needs. Further, they note that unlike public companies, the distribution of many private company financial statements is limited and that many private company financial statement users can request information that public company investors generally cannot. Therefore, there is less need for the detailed requirements of certain standards, and perhaps some of the standards themselves.

For these reasons and because of the growing trend internationally to create separate standards for private companies, many private companies are advocating separate accounting standards for private companies that would be less costly to apply and produce information that is more relevant to users.

# Enhancing financial reporting for all constituents is the best course of action

**Fundamentally, we believe the economics of a transaction should be accounted for in the same manner by all companies, whether public or private, regardless of their sources of capital.**

We believe that the fundamental issues in this debate are not driven by public versus private company differences. Accordingly, we support a single set of high-quality accounting standards.

## *Reflecting economics*

Separate standards for private companies would mean that a company's sources of capital would determine the best way to report transactions. Fundamentally, we believe the economics of a transaction should be accounted for in the same manner by all companies, whether public or private, regardless of their sources of capital.

## *Complexity, cost and relevance*

The issues of increasing complexity in accounting standards and the related increasing costs to comply are common to public and private companies alike. Unfortunately, complex accounting is often necessary to reflect the economics associated with complex transactions.

We advocate simplification of accounting standards where possible for all preparers. If there are simpler alternatives to the current accounting standards that are reasonably faithful to the economics of a transaction, these alternatives should be made available to all preparers.

At times, both public and private companies have questioned the relevancy of information resulting from the application of certain standards to the decision-making processes of their financial statement users. Frequently, these concerns relate to the same standards, and similar perspectives are generally shared by public and private constituents. Addressing the relevancy of financial reporting is equally important for all companies.

## *Operational issues*

Operationally, creating separate standards would be disruptive and would increase costs across the financial reporting system. For example, a lender with both private and public company borrowers would receive financial statements that appear similar, but are based on different accounting principles. The lender would incur costs to learn the two sets of

standards, keep current on both and revise and maintain dual systems for analyzing different data.

A separate standard setting process would need to be governed and monitored. The costs of doing so would likely need to be borne by private companies somehow.

Preparers would need to ensure that their accounting staffs are properly trained in the right set of standards. Auditors would need to do the same depending on the nature of their clients. Two sets of continuing education materials would need to be developed and made available.

Separate standards would create greater barriers for private companies seeking to enter the public capital markets or attempting certain other exit strategies, as companies may struggle to adopt public company standards.

Our educational system would be charged with providing instruction on multiple sets of standards. The costs associated with meeting this educational challenge will be reflected in university tuitions and ultimately the broader economy.

## *A greater voice for private companies*

We are sympathetic to concerns over complexity, cost and relevancy. And steps other than separate standards can be taken. We commend the Board's recently formalized enhanced procedures that require consideration of cost-benefits for private companies in all projects. Further, we recommend that the Board develop a closer working relationship with its private company advisory group, and consider whether a representative from that group should be a participating observer on the Board's task force that addresses emerging accounting issues. We also recommend increased oversight of the Board by the Foundation to ensure that concerns over complexity for all companies and other private company concerns are considered. However, a greater voice is a two-way proposition. Private companies often are not active in the standard-setting process and relatively few submit response letters on proposed standards issued by the Board. More private company constituents should become active in the standard-setting process.

# Questions and answers

**Q:** While maintaining the objective of a single set of high-quality accounting standards, could there still be different requirements for public and private companies?

**A:** Relating to recognition and measurement, the differing cost-benefit considerations for public and private companies could be compelling enough to warrant a difference, although we think these situations would be infrequent. We believe that the cost-benefit analysis could potentially lead to differences in the transition, disclosure, and effective date requirements for private companies when appropriate.

**Q:** What is the impact to private companies if public companies in the U.S. ultimately adopt international accounting standards?

**A:** Although a slower migration, over time we would see U.S. private companies also moving toward the international framework. We believe that the creation of a separate set of ongoing standards for U.S. private companies would create greater divergence between U.S. and international reporting and greater complexity. Financial statement users, investors, educators and students would need to learn or understand both sets of significantly different accounting principles. To avoid this situation, if U.S. public companies move to international standards, private companies may find international standards for "Small and Medium-sized Entities" to be an attractive alternative.

**Q:** Should public companies care about this debate?

**A:** We think they should. Another way of phrasing the question "Should there be separate accounting for private companies?" is "Should there be separate accounting for public companies?" Many of the concerns expressed by private companies are shared by public companies. If there are ways for private companies to address concerns over complexity, cost and relevancy, public companies will be interested in exploring those solutions as well. This simply re-enforces the notion that enhancing financial reporting for all companies, public and private, is the best course of action.

**Q:** How would standard-setting decisions be made if separate standards were created for U.S. private companies? What are the risks?

**A:** In our view, the standard-setting body would need a separate conceptual framework to guide its decision making. The creation of this framework would likely be difficult and time-consuming. There would be no assurances that the efforts to create a sound framework would be successful. Without a sound conceptual framework, there would be a risk that the resulting standards would not be viewed as high quality by users.

## Contact Information

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