2011

Big GAAP vs. Little GAAP

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BACKGROUND

Over the past three decades, a number of organizations have studied the issue of "big GAAP, little GAAP." In the U.S., the AICPA and the FASB have both studied the topic. 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. In most cases, U.S. GAAP currently does not provide for different recognition and measurement principles based on whether a company is public or private; however, U.S. GAAP sometimes provides for differences in presentation and disclosure.

In 2004, the Board of Directors of the AICPA formed a special task force to conduct research to determine if there was an issue with current or forthcoming financial reporting by private (or privately-held), for-profit entities. That is, within the confines of what GAAP financial statements can convey, were the financials meeting the needs of all constituents of that reporting?

In March 2005, the task force unanimously recommended that a process be established to evaluate potential changes to GAAP in order to improve the usefulness of private company financial reporting. The task force based its conclusions on the inputs of more than 3,700 business owners, public accounting practitioners, financial managers, lenders, investors, and sureties.

In May 2005, the governing Council of the AICPA passed a resolution that announced the profession's intent to work with the FASB to evaluate potential changes to GAAP for privately-held, for-profit companies, as recommended by the Private Company Financial Reporting Task Force. In June 2006, the two organizations issued a joint proposal intended to improve the financial reporting process for private company constituents. Under the proposal, the FASB would implement certain improvements to enhance the transparency of its standard setting process for private companies and consider input from private company constituents. Part of the initiative also involved creating a new committee whose primary objectives was to provide recommendations to the FASB as the FASB sets accounting standards for privately-held enterprises.

In March 2007, the Private Company Financial Reporting Committee (PCFRC) announced its founding membership. The PCFRC was part of a broad initiative by the FASB and the AICPA to further improve the FASB's standard-setting process to better meet the financial reporting needs of private companies and the users of their financial statements. The primary objective of the PCFRC is to provide recommendations to the FASB that will help the Board determine whether and where there should be specific differences in prospective and existing accounting standards for private companies. The Committee consists of four CPA practitioners, four financial statement preparers, and four users of private company financial statements.

Blue-Ribbon Panel on Private Company Financial Reporting

In a letter to the Financial Accounting Foundation (FAF) in November 2009, the PCFRC communicated its unanimous decision to recommend that the FAF consider private company accounting issues in the context of the mission of the FASB. The PCFRC went on to state its preference:

> The Committee believes 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…In establishing standards for private company financial reporting, the needs of financial statement users balanced against the costs of complying with the standards must be an overriding principle.

In December 2009, the FAF, the AICPA, and the National Association of State Boards of Accountancy announced the creation of a blue-ribbon panel to study the issue of standards setting for private companies. The panel will make recommendations that address a growing concern about the relevance of accounting standards for reporting entities that do not file financial statements with the SEC.

The Blue Ribbon Panel on Private Company Financial Reporting held its first meeting in April 2010. The 18 panel members, including AICPA President and CEO Barry Melancon, and participating observers represent a cross-section of financial reporting constituencies, including lenders, investors and owners, as well as preparers, auditors and regulators. It is chaired by Rick Anderson, CEO of Moss Adams LLP. The panel is one of the AICPA's top priorities in 2010 and recommendations are likely to come before the end of the year. Many observers believe this panel is unique and holds greater potential for significant movement than any previous effort.

Although some have asked how this group will differ from others tasked with similar efforts in the past, what makes this panel stand out is that it includes representatives of all the key constituents of private company accounting and places a strong emphasis on financial statement user needs and viewpoints. This panel is not about technical decisions, but process. In other words, the real issue is how to get the right set of standards for users. The panel is not looking at any particular standard, which are only symptoms of the problems. Instead, this panel is focusing on whether the process is giving the right answers to companies. And if the answer is no, what would be a better solution.

In recent meetings the panel weighed in on seven alternative models for private company financial reporting, eliminating models that were based on IFRS and a model that effectively would have maintained the status quo. All of the remaining models under consideration by the panel would result in differences in GAAP for privates companies, where warranted, compared with GAAP for public companies.

In addition, the models presented by the panel's staff, recently, represented several variations of models based on U.S. GAAP and IFRS. The panel agreed to focus in on three of the U.S. GAAP-based models to create two or three hybrid models that are more detailed and focused. The three primary models that are advancing for more consideration are:

- U.S. GAAP with Exclusions for Private Companies—with enhancements
- U.S. GAAP—Baseline GAAP with Public Company Add-Ons
- Separate, Stand-Alone GAAP Based on Current U.S. GAAP

Regardless of which model the panel eventually selects to recommend, several panel members said the group that sets those standards needs to understand the needs of the users for whom they are designing the standards. Most of the panel members expressed discontent with the current makeup of the FASB board and noted its heavy—but appropriate—focus on public companies. This was the center of debate on the structure of whatever model is ultimately selected—the current FASB board; a restructured FASB board (with greater private company representation); or a new, separate Private Company Standards Board under the oversight of FAF.

WHAT'S DIFFERENT THIS TIME?

Differential reporting has been studied and restudied. What has changed that could lead to a different result this time? The PCFRC identified four events and trends in the United States and around the world that support a re-examination of private company accounting standards:

- The issuance of the International Financial Reporting Standard for Small and Medium-Sized Entities (IFRS for SMEs)
- Efforts underway in other countries to address private company GAAP (including the recent publication of Accounting Standards for Private Enterprises in Canada)
- Recent surveys of financial professionals in the United States that demonstrate a preference for differential accounting standards for private companies

- The increasing number of complicated accounting standards, driven primarily by public company investor and analyst needs. These are often expensive for private companies to implement and provide far less benefit for the users of private company financial reporting.

IFRS for SMEs

The recent issuance of IFRS for SMEs has raised the discussion to a new level. Issued by the International Accounting Standards Board (IASB) in July 2009, IFRS for SMEs is already recognized as GAAP by the AICPA and could be applied by private companies in the United States. Private companies in this context are defined as companies that do not have public accountability.

This definition excludes companies with shares listed on exchanges, banks, insurance companies and similar entities. IFRS for SMEs is particularly significant because it signals an end to the long-established principle that recognition and measurement must be the same for public and private companies.

Business combinations, financial instruments, intangible assets and other items have mandatory or optional alternative recognition and measurement requirements as well as reduced disclosure requirements. IFRS for SMEs has legitimized differential accounting.

IFRS for SMEs not only includes a set of “stand alone” standards; it also contains a separate conceptual framework for SMEs. This also is significant because it will allow for a different basis for determining future standards. The IASB appears to be signaling that the objective of financial reporting, and possibly even the definition of an asset and a liability, could differ for private companies. It also could be an indication that the joint IASB/FASB conceptual framework project should be viewed as applying only to companies with public accountability, at least as far as the IASB is concerned.

Canada Issues Accounting Standards for Private Enterprises

In December 2009, the Accounting Standards Board of the Canadian Institute of Chartered Accountants made its own contribution to the conversation by publishing Accounting Standards for Private Enterprises (ASPE). Private companies in Canada must choose between applying ASPE or full IFRS for fiscal years beginning on or after January 1, 2011. By issuing ASPE, Canada has accepted the concept of differential accounting for private companies.

The decision by Canada to publish its own standards illustrates how the IASB, despite continued success in establishing its authority over the setting of financial reporting standards for entities with public accountability, has yet to establish its legitimacy as a global standards setter for private companies. Canada rejected IFRS for SMEs while adopting IFRS as the replacement for Canadian GAAP for public companies.

Recent Survey Results

Recent surveys indicate that there is more support for differential recognition principles than there has been in the past and that such support may be increasing rapidly. For example, Grant Thornton LLP conducted a survey of senior financial executives in 2009, and received responses from 846 U.S. CFOs and senior comptrollers. A majority (56 percent) of respondents from private companies agreed that there should be different recognition and measurement principles for public and nonpublic entities. The extent of support increased to 66 percent, however, when the question was rephrased to ask whether private companies should be allowed to use simpler recognition and measurement principles.

Another interesting result was the response to whether private U.S. companies should be allowed to use IFRS for SMEs. In March 2009, only 36 percent agreed. By September 2009, that number had risen to 52 percent. The survey also showed greatly enhanced awareness of the issues.

In addition, a Deloitte survey of more than 220 private company financial professionals in June 2009 showed that more than half (51 percent) of respondents support separate accounting standards for private and public companies.

Complicated Accounting Standards

According to the PCFRC letter to the FAF, the crux of the matter is the increasing number of complicated accounting standards. From the perspective of a private company, these standards are often viewed as less than ideal because they are:

- Oriented toward the needs of financial analysts,
- Expensive to implement (and audit), and
- Based on a model of financial reporting that is not a good fit for private companies.

Standards setters today are highly focused on the needs of financial analysts. Analysts focus on highly liquid markets where the equity of a firm may turn over several times a year.

For many financial analysts, information needs are driven by computerized trading models designed to exploit short-term market inefficiencies and opportunities for arbitrage. Many strategies rely on identifying very small inefficiencies that can produce large profits when the investment is highly leveraged.

Financial statements responsive to analyst needs are expensive to prepare and expensive to audit. The costs of preparing and auditing financial reports would be less of an issue if the data met the needs of private companies. However, private companies and their users are more often interested in accountability to owners and compliance with bank covenants than valuation of equity securities. The information set useful for trading strategies that take advantage of short-term market inefficiencies is virtually meaningless to private company investors.

The focus on financial markets has also led to a change in the underlying accounting model. Supported by 40 years of financial economic theory and research, there has been a gradual change from a traditional, transaction-based model with a focus on realized income to a more complex valuation-based model with a focus on economic income. What has not been established, through research or otherwise, is which model, the traditional or the financial economic, is a better fit for private companies.