Ross Roundtable

On

Big GAAP vs. Little GAAP

Public Company and Private Company Reporting

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Professor Paul Zarowin, Director of the Ross Institute, welcomed the participants to the first Roundtable of the academic year. "The raison d'être of the Ross Institute is to encourage communication between the academic and the professional community by promoting research, debate and discussion of ideas on topics that are timely and important to both groups. The Roundtable on *big versus little GAAP* fits squarely into that paradigm." Accounting curricula have historically focused on traditional GAAP. In recognition of the fact that a "one size fits all" approach is non optimal, research on how to improve the relevance of financial reporting for different size entities is currently in progress at NYU. In support of these efforts, we have convened a distinguished panel of experts from the accounting, finance, and legal professions, as well as regulators, to discuss an important and "timely" issue: a "timely" issue that has been debated for several decades—an issue whose "timeliness" and import have become increasingly more relevant—an issue that many believe "*its time has finally come*".

Historical background:

1972	"The Wheat Report": A Study on Establishment of Accounting Principles (AICPA). The Report created a new standard-setting structure composed of three organizations-- The Financial Accounting Foundation (FAF), the Financial Accounting Standards Board (FASB), and the Financial Standards Advisory Council (FASAC).
1972 – 2005	Numerous studies and reports on GAAP for private companies.
2004	FASB establishes the Small Business Advisory Committee to obtain more active involvement by the small business community in the development of financial accounting and reporting standards.
2005	Private Company Financial Reporting Task Force Report, AICPA ("Castellano Report")
2006	Formation of the Private Company Financial Reporting Committee (PCFRC) to provide the FASB with input on the needs of private companies and the users of their financial statements.
2009	Blue-Ribbon Panel on Standard Setting for Private Companies was formed "to address how accounting standards can best meet the needs of users of U. S. private company financial statements.

2009 AICPA Council expresses overwhelming support for GAAP differences for private companies

2011 Blue Ribbon Committee submits their recommendations in a "Report to the Board of Trustees of the Financial Accounting Foundation (FAF).

2011 The FAF announced the creation of a Trustee Working Group to address issues associated with standard setting for nonpublic companies.

2012 The FAF established The Private Company Council (PCC). The PCC has two major responsibilities:

1. The PCC and the Financial Accounting Standards Board (FASB), working jointly, will mutually agree on a set of criteria to decide whether and when alternatives within U.S. Generally Accepted Accounting Principles (GAAP) are warranted for private companies. Based on those criteria, the PCC will review and propose alternatives within U.S. GAAP to address the needs of users of private company financial statements.
2. The PCC also serves as the primary advisory body to the FASB on the appropriate treatment for private companies for items under active consideration on the FASB's technical agenda.

For several decades small, private companies and their auditors have become increasingly frustrated and vocal about the escalation in overly burdensome and costly authoritative standards. Their complaints include, but are not limited to:

- The needs of users of private company financial statements are being neglected.
- There is an insufficient weighing of the costs of using GAAP and benefits thereof for private company financial reporting.
- No consideration is given to whether variable interest entities (VIE), uncertain tax positions, fair value measurements, and goodwill impairment are relevant for private companies, and thus whether GAAP public company standards should apply to private companies.

A major problem facing regulators is that the terms, "nonpublic," "private and "small" are used interchangeably. Private does not necessarily imply small. 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. Yet, the financial transactions of many private companies are no less complex than their public counterparts. Forbes.com reported (November 3, 2010) that the top 100 private companies had estimated mean average annual revenues of over $10 billion with a median of just under $6 billion. Where should the line of demarcation be drawn or what threshold should be used to determine if private company GAAP is applicable? This is a very contentious issue.

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." Among the 25 recommendations presented was the need for "the presumption that formally promulgated alternative accounting policies should not exist. 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."

And the debate continues…..

Professor Seymour Jones, (Associate Director, Ross Institute), moderated the panel. He put forth the position that having one set of accounting standards, U.S. GAAP, is preferable and the anticipated merger with the International Accounting Standards Board (IASB) is not in the best interests of our country. In addition to introducing the panel of experts, presenters were challenged to defend their positions, thus setting the scene for a very lively discussion and debate.

Viewpoints from the accounting profession

Historically, accounting standards were designed for SEC registrants. It is the large, publicly traded companies that exert the greatest influence. In addition to their size both in terms of revenues and shareholders, extensive media coverage of their activities and results of operations have been a driving force for promulgation of complex standards. The onerous burden of the complex standards and the overload thereof on private companies remained in the shadows. Many accountants believe that standards will continue to focus on the needs of the sophisticated users.

There are 28 million business entities in the U. S., of which 14,000 are SEC registrants. The majority of these 28 million firms produce non-GAAP, other comprehensive bases of accounting, e.g. cash basis, tax basis, or a modified accrual basis, financial reports. Do we need another set of authoritative standards for private companies? Who will be the beneficiaries thereof? What are the consequences of having yet another set of standards? Economists use the term network externalities to describe the complications created when simplification for one sector creates complications in other areas: an adequate description for what currently remain the unknown consequences of adopting two sets of competing standards.

Suggestions were made that a modification of GAAP for entities meeting a defined set of criteria would be preferable to creating a separate GAAP. However, multiple-choice alternatives reduce both comparability and consistency. Canada and the UK adopted international standards for their public companies and maintained a slimmed down version of their existing GAAP for their non-public companies. The IAS promulgated a parallel simplified IFRS for what is called SME's, a small or medium size enterprise. In addition to the typical criteria for comparison, e.g. capital structures, business models, economic environment, etc. "customs" are a pervasive driving force that sets our countries apart. According to this view, our small, privately owned entities need "home-grown" standards designed for the American way of doing business.

Accounting firms find that the most difficult issues facing some of their clients are accounting for intangibles, goodwill, variable interest entities, derivatives and consolidations. Small private companies have to incur the costs of outsourcing the preparation of their financial information to more sophisticated, high-priced professionals: costs for which they fail to see the benefits. The demand for simplification is increasing, and extends to public companies as well.

It is important to step back and ask, "Are we trying to reduce the complexity in accounting to reduce the burden on the preparer of the report, or are we trying to improve the usefulness of financial statements for the users? Is this a tradeoff or are they two sides of the same coin? The objectives of financial reporting clearly state that financial information should provide information that is *useful* in making rational investment, credit, and similar decisions. However, the pervasive constraint that the benefits of providing the information should exceed the costs thereof cannot be ignored.

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"Isolated events, what is known as the 'Enron effect', should not be permitted to affect 28 million private companies." This is not an "isolated" statement. The term *outcry* from every sector of the economy would be a more apt description. We have a long history of hastily enacted legislation and promulgation of standards in response to accounting scandals; scandals that instigated media-fueled public outcries.

Accountants who serve small private companies have an ongoing relationship with management and a good working knowledge of the businesses that they serve. In the past decade they have found it increasingly difficult to serve their clients in an efficient, cost-effective manner. Clients are trying to understand why their financial statements do not correspond to the economic reality of their financial position. And why do they have to carry the burden of extra costs of preparing financial reports that do not provide relevant information for users of these reports? It is difficult to come up with an intelligent explanation when you know the client is right. "If you want an unqualified opinion, you have no choice" is not what the client wants to hear.

Non-GAAP accounting, e.g. cash or tax-based accounting, results in useful end-user reports for a majority of independently owned businesses. Adhering to GAAP by consolidating a business that meets the definition of VIE is not only confusing but very costly. GAAP required recognition and measurement using fair values add another layer of complexity, onerous disclosures, and ultimately excessive cost. However, if the company does not receive an unqualified opinion on GAAP financial reports, its access to lending institutions is impaired, and the costs of borrowing go up. Recognizing the needs of small, privately-owned firms is long overdue. Change is long overdue.

Perspective from the legal profession

Financial reporting in the U. S. is inherently different than in most countries. In other countries financial accounting is statutory. The European Union's [EU] founding treaties give the EU authority to develop laws to regulate accounting and auditing for the member states. In Germany, there are detailed statutes governing financial reporting requirements. In this country we are both proud and appreciative that although the federal government (SEC) has the statutory authority to establish financial accounting and reporting standards for publicly held companies, it has delegated the authority to the private sector. Accounting standards were historically designed for large, publicly traded entities. In other countries, statutes mandate different accounting and reporting based on size, capital structure, ownership, etc. It is the government, and not the private-sector user of the financial information, that dictates reporting requirements.

In the U.S. we have a mandatory structure for financial reporting by publicly traded companies. Private companies may elect to implement GAAP. They do so to achieve credibility with investors, creditors, and other stakeholders. An unqualified audit report is their "key" for access into the "market"-- public or private. The creation of the PCFRC and implementation of a private company framework have been huge steps in the right direction. Efforts are also being directed towards simplification of the accounting standards for all sectors of our economy. However, what a vast majority of firms need are a set of standards that permit reporting below the level of the FASB; standards that provide consistent and meaningful financial reports. In response to this need, the AICPA created a financial framework for small and medium size entities. The adoption of non-GAAP AICPA standards by firms will ultimately depend on their acceptance by stakeholders, lenders, and other interested parties.

Professor Stanley Siegel (NYU, Law) opined that in our current global economy, the merger of GAAP and IFRS is inevitable. Multi-national firms require consistent and comparable standards. When the merger is completed, he believes it will be in the format of GAAP; GAAP is computerized, hierarchical, and the codification is light years ahead of the IFRS structure. However, when it comes to small companies, he believes that international accounting standards are not applicable. Thus the AICPA's framework for small companies will become increasingly relevant.

One of the problems that has impeded the improvement of GAAP, by creating barriers to full disclosure, is our culture of enforcement by private litigants. In countries where there is less fear of litigation this is not an issue. This issue will also make convergence more difficult. In Germany a third party user of financial statement generally does not have any basis for suing for misstatement. It is the client who has the right to sue the accountant. The client hires the accountant; the client can hold the accountant to the standards. It appears that we in the U. S. have become so fixated on the idea that the accountants should be liable for what they do, that we have lost sight of the fact that we are standing in the way of their doing their job in the most efficient way possible.

The complexity of accounting standards is another fallout of our litigious society. The accountants have no choice but to insist upon standards that detail every conceivable transaction. They do so to avoid the pitfalls of using their professional judgment and having to defend their professional judgment to a jury that is not a *jury of one's peers*.

The AICPA creates a Framework for Private Company Accounting

The owners and managers of millions of private companies have multiple accounting frameworks from which to choose. Ultimately, it is the users of their financial reports, e.g. lenders, insurance companies, suppliers, or investors that dictate their choice. Members of the accounting profession voiced their opinion that there should be one set of GAAP in the U.S. with alternatives to meet the needs of private companies. The AICPA has a long history of trying to improve private company financial reporting, and has been working with the FASB and National Association of State Boards of Accountancy (NASBA) towards that end.

Non authoritative accounting, (non GAAP, e.g. the cash or tax basis of accounting), has worked well for many firms. However, it has not met the reporting needs for a large sector of private firms. In response to a market-place demand, the AICPA developed a new "Financial Reporting Framework for Small & Medium Size Firms[1]" [FRF for SME's]. The framework is a valuable resource, custom-tailored to meet the needs of the small and medium size firms and the

[1] http://www.aicpa.org/interestareas/frc/accountingfinancialreporting/pcfr/pages/financial-reporting-framework.aspx

users of their financial information. It is streamlined, simplified, and cost effective. The option of using historical cost accounting (as opposed to fair value) is one example of the simplification and relevance of the alternatives provided. Simplified guidelines are presented for consolidation based on ownership. The small company arena provides an old-fashioned, unsophisticated version of "real-time" reporting. Users generally have an ongoing relationship with management and have first-hand knowledge of the business.

The AICPA has been paving the way for acceptance of their framework with concerted efforts towards educating the targeted consumer by providing the information and resources to assist in understanding the FRF for SME's. Meetings with representatives of banking institutions and regulators at both the national and state levels have been encouraging. The message: "The framework is built and backed by the AICPA; financial reports prepared using the framework will be *informative, relevant, and reliable*."

Perspective from the FASB on nonpublic entities

The creation of the Blue-Ribbon Panel on Standard Setting for Private Companies (2009) was formed "to address how accounting standards can best meet the needs of users of U. S. private company financial statements". The panel was jointly sponsored by the FAF, along with the AICPA and NASBA. The panel issued its report in early 2011 with recommendations on how to make systemic improvement in GAAP standard setting for private companies. The report called for a better cost benefit balance and the continued use of GAAP for public and private companies, with exceptions and modifications made for private companies. A balance that the Panel believes can be fostered by two major changes.

1. The creation of a separate board under the FAF to work alongside the FASB but to have the final say on standards for private companies.

2. The creation of a decision making framework that would serve as a guide for the separate board and the FASB to use in their efforts on behalf of private companies.

In response to the recommendations, the FAF board of trustees created the Private Company Council [PCC]. Although the PCC sets its own agenda and has many of the attributes of a separate board, it stopped short of being totally separate from the FASB and its process. The PCC is the primary advisory body on behalf of the private company sector for all ongoing FASB projects.

The Blue Ribbon proposal for the formation of a private company framework has been fully embraced by the FAF and FASB and is set to be released within a month. The framework is not a new conceptual framework; it is a decision-making tool that has been "right-sized" for the private company sector. The objectives of financial reporting have always been to provide information that is "useful to the end user". The disparity between users of private and public company financial reports and the information that is relevant for each sector has to date been neglected.

The PCC has issued proposed GAAP alternatives in the areas of intangibles recognized in business combinations, goodwill, derivatives and VIE situations. These areas are not only insignificant for many private firms, but the costs incurred in preparation of the reports have been onerous with little or no benefit. The proposals have received the required FASB endorsement and are also subject to public due process.

FASB—work in progress

A review of disclosure requirements is currently in process at the FASB and anticipated to be next on the PCC agenda. The collaboration of the PCC and FASB on this issue will hopefully result in changes that not only simplify disclosure requirements for private companies, but will simultaneously lead to improvements of disclosure requirements in the public sector. There are many overlapping areas, and as the saying goes "there is nothing like having a fresh pair of eyes" taking a look. The FASB has placed a standing project on its agenda to assess the appropriateness of PCC proposals for public companies, not for profits, and employee benefit plans. The integrated standard setting process has the potential for initiating overall improvements and providing a better cost-benefit balance. As the process continues to evolve, they will be looking at the public and private sectors simultaneously, with similar robustness, in trying to find the best simple solution for all entities. The entirety of U.S. GAAP will continue to reside in the *FASB Accounting Standards Codification*™, along with the exceptions and modifications for private companies.

We are living through changing and uncertain times, and what appears to be an inevitable merger of U. S. GAAP with the IASB. The FASB continues its efforts to simplify and improve U.S. GAAP for all sectors—and at the same time—work with the IASB in what appears to be the final chapter of the decades-long process that started with harmonization, escalated to convergence, and at the final stage—will result in merger. The FASB remains determined that the merger will not be at the expense of what is best for investors in the U.S. capital markets.