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LETTER OF COMMENT NO. 8

Committee on Private Companies

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File Reference: Proposed FSP FAS 154-a

Dear Mr. Smith:

The Standards Subcommittee of the Committee on Private Companies (“CPC”) of Financial Executives International (“FEI”) wishes to share its views on Proposed FASB Staff Position (FSP) FAS 154-a – *Considering the Effects of Prior-Year Misstatements When Quantifying Misstatements in Current-Year Financial Statements*. FEI is the leading advocate for the views of corporate financial management in the United States. It is a professional association of more than 15,000 CFOs, treasurers, controllers and other senior financial managers. With approximately 7,500 members from private companies, FEI has a strong base of knowledge to draw upon with regard to the financial reporting needs and requirements of the private sector.

The CPC is a technical committee of FEI, which formulates private company positions for FEI in line with the views of the membership. A list of the members of our standards subcommittee is attached to this letter. The sizes of our private companies range upward to in excess of one billion dollars in revenue. Respondents to a recent survey of the FEI private company membership indicated that 51% of their companies have revenues above one hundred million dollars, and about 10% have revenues above one billion dollars. Our committee’s views represent those private companies that do not plan to access the regulated public markets in the foreseeable future. This letter represents the views of the Committee on Private Companies, Standards Subcommittee, as a whole, and not necessarily the views of FEI.

In our view, the proposed FSP does not appropriately improve financial reporting for the following reasons:

- (1) The proposed FSP is not user-based.
- (2) The costs of implementation of the proposed FSP exceed the benefits to users.
- (3) The proposed FSP is not a principle of financial reporting.
- (4) The proposed FSP is inconsistent with the Conceptual Framework.
- (5) The proposed FSP sets a dangerous precedent for regulation of private companies.

Our specific comments on each of these reasons follow.

(1) The proposed FSP is not user-based.

We believe that the proposed FSP is not user-based for two reasons:

- (A) It does not consider the needs of private company users, and as a result,
- (B) It decreases, instead of improves, the qualitative characteristic of understandability.

(A) The proposed FSP does not consider the needs of private company users.

We do not believe that the proposed FSP appropriately differentiates between the needs of the users of private company financial reports and those of public companies. We note that the minutes of the December 19, 2006 FASB Board meeting record that the request for the proposed FSP originates with the Big Four accounting firms. We do not believe that requests for conformity *per se* from auditors form the basis for user-based standards of financial reporting. Nor do we agree with the view that financial reporting standards should be conformed to the practical implementation audit procedures of Big Four firms. Instead, we agree with the reservations expressed in paragraph six on page four of the minutes which read: “[Board member] Mr. Young questioned whether it was prudent to delegate the setting of accounting standards for private companies to accounting firms. [He] expressed concern with this ad hoc approach, and conveyed the view that the Board should determine the appropriate accounting standards for private companies.”

We do not agree with the FASB staff’s *assumption* that larger private companies have accumulated large passed audit adjustments. The minutes of the same December 19 meeting record that a FASB project manager states that “this class of larger private companies *likely* has passed audit adjustments that are accumulated over time.” [Emphasis added.] Based on our subcommittee members’ first-hand experience and our anecdotal knowledge, it is *unlikely* that private companies accumulate passed audit adjustments. We believe that the FASB staff’s assumption that our behavior as private company preparers imitates that of our public company peers fails to consider who our private company financial statements users are and how they use GAAP-based financial reports.

The SEC issued SAB 108 in response to the problem of passed income statement adjustments, at the time immaterial to earnings, which have built up on the balance sheets

for some public companies. These companies were reluctant to flow these accumulations back through earnings because of their strong focus on periodic earnings management. The SEC's stated mission is to protect *investors* in public companies. These investors demand comparable, historic earnings and earnings per share numbers in order to assist in their *valuation of equities*. In SAB 108, the SEC has provided a mechanism to allow public companies to avoid distortion of this periodic earnings stream, and also to make a one-time clean-up resulting from past equity market driven behavioral patterns of their financial reporting.

Private company users are different. Our committee members' experience, confirmed by the CPC's newly released survey titled *FEI Private Company Survey, March 2007*, is that the primary users of our financial statements are not equity investors, but instead consist of two well-defined classes: bankers and "closely-held" company owners. The primary focus of these two groups is on current liquidity, cash flow, and stewardship of management. For example, our asset-based lenders want to know that our working capital balances on our balance sheets *at the balance sheet reporting date* are free from material error. They are unconcerned about when and how corrections appear in the previously displayed years of "earnings". (Private companies are not required and generally do not include earnings per share information in their financial reports.) Likewise, our owners are interested in the most recent report on the cash-flow generated by the operations of the business, and are not concerned with accounting mechanisms that determine how either previous years' earnings or prior balance sheet accruals and valuation amounts are recast for comparability purposes. Accordingly, as private company preparers, our behavioral patterns conform to the different needs of our private company users. To convert an SEC generated materiality test designed to protect equity investors in public companies into a standard of financial reporting for private companies at the request of Big Four auditors is to impose regulation on private companies that does not benefit private company users.

(B) The proposed FSP decreases, instead of improves the qualitative characteristic of understandability.

Statements of Financial Accounting Concepts No. 2 – *Qualitative Characteristics of Financial Information* defines understandability in its glossary of terms as "The quality of information that enables users to perceive its significance." CON2 goes on to say that the "understandability of information is related to the characteristics of the decision maker as well as the characteristics of the information itself, and therefore, understandability cannot be evaluated in overall terms but must be judged in relation to a *specific class* of decision makers." [Emphasis added.] Since the proposed FSP is specifically directed to private companies, then the level of understandability created by this proposed FSP must be specifically judged in relation to the specific class of private company users.

In our many years of interaction with private company financial statement users we do not doubt that our users have an acceptable, traditional, and working understanding of the currently pervasive concept of materiality provided by CON2 and restated as follows in

the proposed FSP: “The magnitude of an omission or misstatement of accounting information that, in light of the surrounding circumstances, makes it probable that judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.” Our experience with our private company users is that they believe that audited financial statements prepared in conformity with GAAP are materially free from misstatement. Private company users have been comfortable with this pervasive principle of materiality for decades. They are aware that when material errors are discovered, they are corrected. They are not concerned with the mechanics of materiality, nor with mathematical rules (and are probably unaware and would not care to know that our auditors routinely use specific mathematical formulas as an audit method for determining if proposed adjusting entries are material or not).

We believe that the proposed FSP unsettles the understandability of this established and accepted process by introducing complexity that lessens the well-accepted principle of materiality. This complexity occurs in two ways.

First, the proposed dual method requires the private company user to understand that there are now two separate standards of materiality – one for the balance sheet and one for the income statement, and that restatements of either or both are governed by a mechanical process than can only be comprehended by study of the rules instead of the traditional acceptance of a long-standing principle.

Second, private company users will be confused by the implementation of the proposed FSP. At least one Big Four firm has suggested that private company auditors heed the SEC staff’s recommendation regarding non-labeling of immaterial prior year restatements: “The subsequent financial statements need not be labeled ‘restated’ and the adjustments would not necessarily be mentioned in the auditors’ report.” Based on our experience, making any change in prior years’ financial statements previously supplied to our owners and bankers without explanation lessens credibility and, therefore, lessens understandability.

On the other hand, attempts at explaining the principle contained in the proposed FSP will also be confusing to the user. If the established disclosure practice of identifying newly adopted accounting standards is followed, then a footnote explaining the standard would appear in the financial statements. If, in addition to explaining the standard, a restatement of previously issued, error-free financial statements is required, then the language of both the standard and its implementation becomes complex and confusing. Stating that the “roll-over” method required an adjustment, which in turn caused the “iron-curtain” method to require an adjustment, which in turn caused previously issued, error-free financial statements to be adjusted and then reissued – even though those previously issued statements were and still remain error free -- is not a flow of logic that improves the understandability of financial reporting.

In summary, private company financial statement users have understood, and continue to understand, the “reasonable person” definition of materiality. The proposed FSP rules are substantially less understandable.

(2) The costs of implementation of the proposed FSP exceed the benefits to users.

Given our views in (1) above, the threshold for acceptable costs of implementing the proposed FSP is low to nonexistent. Additional costs will be incurred by private companies in three areas.

First, private company audit fees will be increased by a new, more time consuming audit mechanism. Using the example of paragraph 9a in the proposed FSP, if a potential audit adjustment is not material using the rollover method, it must then be tested by the iron curtain method. If a potential audit adjustment is judged to be material by the rollover method, then after making the current year income statement correction, the resulting correction must still be subjected to the iron curtain test. Thus, *all* potential audit adjustments must be tested by *both* methods. No longer can a potential adjustment be professionally judged by a simple, established principle of materiality. Practically, auditors will develop algorithms with stated numerical error ranges and consume considerable (and billable) time running all potential audit adjustments through the models. No audit adjustment will be truly “passed”; all will be evaluated mathematically. (This will also, of course, make materiality just a rule and not a concept resulting in the exact opposite intention of SAB No. 99, *Materiality* which emphasizes the SEC’s staff view that “registrants and auditors should not exclusively rely on any percentage or numerical threshold”.)

Second, private companies will incur additional costs of restating prior year statements (in years beyond the initial implementation year of the proposed FSP). Private companies can have very complex financial statement consolidations. In order to comply with multi-state succession planning laws and estate tax regulations, many private companies have legal and capital ownership structures that are much more complicated than similar-sized public companies. Because private companies rely to a great extent on their auditors for preparing complex consolidations of financial statements, the cost of re-consolidating prior years can be high.

Third, private company preparers are also “explainers” of the financial reports. Over the past few years, rules-based standards have required more and more of our time explaining, quantifying, and even carving out of our financials statements the impact of these newly adopted rules. We believe the proposed FSP will likely require us as explainers to spend even more time educating our users on the mechanics of the materiality rules.

(3) The proposed FSP is not a principle of financial reporting.

We have noted that an exposure draft was issued by the Audited Standards Board (ASB) proposing to adopt in its own audit standards the dual method adopted by the SEC for its public registrants. We disagree with the ASB’s withdrawal of the exposure draft based on their perception that this is an accounting issue. We also believe that it would have been entirely appropriate for the SEC, after granting a one-time cumulative correction, *to simply instruct the PCAOB to incorporate the dual method into its own audit standards.* Had the SEC done so, it is reasonable to assume that no proposed FSP directed toward

private companies would have been issued. The principle of materiality already exists in the accounting standards. We reiterate that the desire for conformity between the audit procedures of public and private companies is no justification for the issuance of an FSP. We have also noted that not all large accounting firms agree with the need to issue this FSP. In the FASB's December 8, 2006 public meeting with its Small Business Advisory Committee, we noted that the Executive Partner and Chief Executive Officer of Grant Thornton, LLP, the auditor of many large private companies, expressed the view that the proposed FSP was not needed, and that current practice did not need to be changed.

(4) The proposed FSP is inconsistent with the Conceptual Framework.

FEI recently issued its *Four Point Plan to Combat Financial Reporting Complexity*. Included in its four points is a call to the standard-setters to complete the Conceptual Framework. Other constituents, including our committee in a prior comment letter, recommend giving the Conceptual Framework authority in the GAAP hierarchy. Developing accounting principles that adhere to a completed framework reduces complexity and increases understandability. The proposed FSP does not appear to be in conformity with the existing and proposed framework.

Statements of Financial Accounting Concepts No. 6 – *Elements of Financial Statements* along with the proposed revised definitions of the elements in the FASB/IASB's joint conceptual framework project intentionally create a sequential financial reporting order. Assets are defined first in FASB/IASB's working document because they are "the most fundamental real-world economic phenomena that financial reporting seeks to display". If the definition of an asset is "too vague or subject to interpretation, then the foundation of financial reporting is at risk of being undermined". CON6 further establishes a financial reporting order when it defines comprehensive income as *dependent* on changes in net assets: "Comprehensive income is the change in net assets of the entity during a period from transactions and other events and circumstances except those resulting from investments by owners and distributions to owners." Net assets are either materially free from misstatement or they are not. If, according to the framework, changes in comprehensive income derive from changes in net assets, the opposite cannot be true. Therefore, conceptually, material misstatements in income cannot occur independently of the balance sheet (except for classification errors within the body of the income statement). Adhering to this concept, the "sales-cutoff error" example in paragraph 10 of the proposed FSP results solely from a misstatement of accounts receivable on the beginning and/or ending balance sheets. That misstatement in accounts receivable, if material, is corrected in the balance sheet with the corresponding adjustment flowing through comprehensive income. (We note with interest that the SEC did not impose a third materiality test method for the cash-flow statement, obviously because the SEC recognizes that the cash flow statement elements derive from changes in the *higher order* financial statements.) The proposed FSP's *independent* testing of materiality in the income statement is contrary to the financial statement order of the Conceptual Framework. We reiterate FEI's call to the standard-setters to finish, *and adhere*, to the framework.

5) The proposed FSP sets a dangerous precedent for regulation of private companies.

We are pleased and supportive of efforts to re-establish principles-based accounting in the U.S. However, we are also practical observers of the increasing issuance of accounting rules resulting from the regulatory and legal environment surrounding public companies. We have concerns that this regulation and associated costs are getting pushed down to private companies and will do substantial damage to our ability to remain competitive in international markets, borrow sufficient funds from our bankers, and provide acceptable cash flows to our owners. We are concerned that passing down the requirements of SAB 108 to private companies leads to a slippery slope of harmful private company regulations. We believe the FASB should recognize the dangers of setting such a precedent and refrain from implementing the proposed FSP.

Our Views on Materiality

Our views on corrections of material misstatements in financial reports are as follows:

- (1) The current definition of the principle of materiality works as intended for private company users and should be left intact.
- (2) Private companies and their auditors should continue to agree on making or passing audit adjustments just as they have in the past without further “guidance”.
- (3) Materiality should be applied to balance sheet accounts only.
- (4) Prior periods should not be adjusted unless the balance sheets of those prior periods contain material errors.

In closing, we appreciate the opportunity to participate as constituents in the independent accounting standard-setting process. As private company preparers who interact with our users, we would be happy to discuss further with the FASB Board and staff these views that we have presented from a private company perspective.

Sincerely,



Andy Thrower
Chair, Standards Subcommittee of the Committee on Private Companies
Financial Executives International

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