AICPA/FAF/NASBA “Blue Ribbon” Panel on Standard Setting for Private Companies
Responses to Questions

See the attached form for my information.

As a CPA practitioner, I’ll skip over question 2 and start with question 3.

Question 3a) Issues or concerns with current GAAP accounting:

Issue #1 – GAAP accounting was never intended to serve the needs of “internal managers.” At least, that’s what I was taught when I earned a Masters in Accountancy at Bowling Green State University in Bowling Green, Ohio (1981). Instead, GAAP accounting was intended to serve the needs of “external users” – creditors, bankers, investors, and other lenders. External users have very different needs than internal users. External users read financial statements of countless companies across all industries. When they see Inventory on the balance sheet, they can quickly understand what it represents. They don’t have to call the company financial manager and ask what’s in the account. If they had to call each company they looked at and ask about the content of each line item on the financial statements, they’d never get a financial evaluation done. Therefore, a common set of accounting rules applied by all companies meets their needs by allowing them to quickly and effectively evaluate many potential deals. And it meets the needs of the companies by allowing them better access to lenders (lenders aren’t backlogged reviewing other deals).

As for internal managers, one common set of accounting rules can become problematic. For example, internal managers should be able to call Inventory whatever they think makes sense. Say my company manufactures widgets. As each widget moves through the production process, my accounting department adds labor and overhead costs to the Inventory account. The offset is a credit to my operating statement. Crediting my operating statement incentivizes me to build inventory. But the lean manufacturing techniques I’m using to run my plant remind me to minimize inventory. I now have an accounting department at odds with my manufacturing strategies. Not good. Issue #2 – I need accounting rules that match my business rules.

Overhead absorption leads to other problems as well, namely, bad decisions. The key is relevance. When internal managers blindly add overhead absorption rates to what if scenarios, they almost always bring irrelevant costs into their analyses. That often leads to bad decisions. For example, say the widget my company manufactures sells for $10 each. The raw material cost is $4 per unit and my labor/overhead rate is $5 per unit. Total cost to make one widget is $9. Now suppose my salesman comes to me and says he can get an order for 100,000 widgets, but only if we agree to sell the widgets for $7 each. My typical accounting department is going to tell me that we’ll lose $200,000 on the order. So, I decline. In reality, I just lost the opportunity to make $300,000. How so? The labor/overhead rate of $5 may be irrelevant to this decision if I have the capacity to produce the widgets. If I don’t buy a new machine, and I don’t hire any more employees, then the labor and overhead costs don’t change in this example. Thus, those costs are irrelevant to the decision and should have been omitted from the cost calculations. Even if I had to incur some overtime, I still come out ahead taking the order. The point is that manufacturing companies don’t sell widgets, they sell capacity. Issue #3 – I need an accounting system similar to a contribution margin approach and not a cost of goods sold approach.
Issue #4 – I need a balance sheet that is relevant to my financial position. Historical cost distorts long-term assets and equity portions of the balance sheet. Say my company has five acres of land that Grandpa bought forty years ago (when he started the company) and it’s valued on the balance sheet at $50,000. Does that make any sense? And does it make any sense to have equipment that’s still producing widgets everyday valued at $0 because it’s fully-depreciated? Think about retained earnings. Does it make any sense to add $1 of income earned today to the same $1 of income Grandpa earned forty years ago? Even though the balance sheet looks good because it balances, in reality it’s grossly distorted and not representative of my company’s true financial position.

The balance sheet distortions may also contribute to an operating statement that looks better than my operations really are. Because my equipment is old and fully-depreciated, my operating statement doesn’t include any costs for equipment (other than perhaps maintenance costs). I run the risk of thinking my company is profitable until I’m forced to buy new equipment. I can’t afford new equipment because I priced my widgets too low, or I allowed my operations to run too fat, or both.

This distortion does not serve the external user well either. He gets a distorted picture of the collateral he’s using to back the loan.

In summary, internal managers need financial reporting systems that match their business models while external users need financial reports that they can review and digest quickly. Where FASB may help internal managers is with building financial models that are future oriented. Accountants are still blamed for driving the car looking through the rear view mirror. We should have solved that dilemma long ago.

Question 3b) My issues are systemic. I believe the fundamental principles of accounting should be challenged and re-examined. I’ve addressed historical cost above. The matching principle can be problematic, too. Money flows naturally, but the matching principle forces accountants to try to make money flow unnaturally by taking water from one part of the stream and moving it to another part of the stream. Eventually, the true flow of the stream is no longer recognizable.

For example, production labor and overhead costs are incurred this period, but I have to move them to the balance sheet and recognize them later when I sell the items they made. Who cares? My operations are receiving, producing, storing and shipping products all in a natural flow. Why can’t that activity be captured on one statement as it occurs rather than splitting off a portion of my costs and putting them on the balance sheet? My suggestion is for the Panel to consider fundamental principles that result in financial statements that show the company’s natural flow of financial resources.

Question 3c) My concerns impact both private and public companies equally. Public versus private doesn’t change the underlying financial reporting needs. Internal managers in either situation have the same needs. I think external users have the same needs, too. However, public companies are in a political environment that private companies are not. You probably understand how that impacts the Panel’s work better than I.

Question 4) Short-term, I suggest that the Panel digest the comments it receives with the goal of understanding the current reality for the financial reporting world of private companies. Long-term, I suggest that the Panel challenge the following conflict: Internal managers often find themselves in a conflict between choosing accounting methods that minimize taxable income versus accounting methods
that maximize reported income to the bank versus accounting methods that tell them what's really going on.

I believe that internal managers should design accounting practices that match their business models. But it's too tempting to use accelerated depreciation methods, or LIFO inventory calculations, in order to manipulate taxable income. The fundamental flaw is our tax system that's based on income. It encourages the politicizing of accounting methods. It also encourages the need to keep two sets of books. It puts pressure on FASB to bend to the wishes of special interests. In the end, accountants follow whichever accounting method gets them closest their objective – minimize the income tax.

Dealing with the income tax system may be outside the Panel's scope, but I hope it's not. Regardless, they need to consider its impact on their decisions.

Question 5a) If the SEC requires public companies to adopt IFRS, so be it. The Panel still has a great opportunity to provide a leadership role in fixing what's wrong with current standards from which at least private companies can benefit. Public companies may benefit as well, especially if they have the resources to keep an IFRS set of books, an income tax set of books, and a logical set of books.

Question 5b) In my view, the biggest outside factor is the income tax system. I don't favor a value-added tax because its sole purpose is to provide a hidden means for taxing us. I see it as a political weapon, or at best, gimmick. My suggestion is to abolish the corporate income tax altogether and replace it with a national sales tax. That form of taxation is visible to all and removes the temptation to manipulate income. That allows internal managers to design financial reporting systems that match their business models. It also allows FASB to design accounting standards without pressure from special interests.

Question 6) Good luck!

Question 7) These responses represent my individual views from nearly thirty years of experience as an audit manager in a Big 6 firm, Controller and then Operations VP in a manufacturing company, and business consultant today. I hope you found them helpful.

Sincerely,
Culver S. Lamb, CPA
513-831-2362
576 Common Wealth Drive
Cincinnati, OH 45244