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Financial Accounting Series

INVITATION TO COMMENT

Enhancing the Financial Accounting and Reporting Standard-Setting Process for Private Companies

A Joint Proposal by the Financial Accounting
Standards Board and the American Institute of
Certified Public Accountants

Comments are requested by August 15, 2006.



Financial Accounting Standards Board
of the Financial Accounting Foundation



Responses from interested parties wishing to comment on this Invitation to Comment must be *received* in writing by August 15, 2006. Interested parties should submit their comments by email at the webpage www.pcfrr.org. If you experience any difficulties, please contact Ms. Sharon Macey at smacey@aicpa.org. Those without email may send their comments to “Technical Director—File Reference 1310-100” at the address below. Responses should *not* be sent by fax.

All comments received are considered public information. Those comments will be posted to pcfrr.org and will be included in the project’s public record.

Any individual or organization may obtain one copy of this Invitation to Comment without charge until August 15, 2006, on written request only. *Please ask for our Product Code No. ITC 21.* For information on applicable prices for additional copies and copies requested after August 15, 2006, contact:

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Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116



SUMMARY

The Financial Accounting Standards Board (FASB or the Board) and the American Institute of Certified Public Accountants (AICPA) recognize the importance of for-profit private entities (private companies) to job creation, to entrepreneurialism, and to the overall vitality of our nation's economy. Both organizations share a commitment to the needs of constituents of private company financial reporting. In line with this commitment, the FASB and the AICPA recognize the need to carefully evaluate whether financial reporting standards meet the needs of users of private company financial reports and whether the changes can be implemented by private companies in a cost-effective manner.

The FASB and the AICPA are committed to exploring ways to enhance the value, transparency, and cost effectiveness of financial reporting for private companies. This proposal further reflects the mission of the FASB as the standard setter in the United States to establish and improve standards of financial accounting and reporting for both public and private companies.

Specifically, this document proposes (1) to make certain improvements to the FASB's current processes for determining whether differences are needed in prospective and existing accounting standards for private company financial reporting and (2) to sponsor a committee designed to increase private company constituent input in the standard-setting process. In assessing the need for differences for private companies in recognition, measurement, disclosure, and presentation, the FASB will consider the needs of users of financial statements as well as cost-benefit considerations.

ISSUES FOR RESPONDENTS

The FASB and the AICPA welcome comments from all interested parties, especially those involved in financial accounting and reporting activities of for-profit private entities (private companies). Included are owners, preparers, CPA practitioners, and those that receive private company financial reports, including lenders, investors, and bonding agencies. The section titled “Modifications to the Standard-Setting Process to Improve Private Company Financial Reporting” (paragraphs 16–29) contains the joint proposal for enhancing the accounting standard-setting process. Paragraphs 1–15 provide important background information that may help in understanding and responding to this proposal.

When commenting on aspects of the proposal, regardless of whether you agree or disagree, please include the reasons for your comments and alternatives that could be considered. The following are some specific questions for your consideration. However, please feel free to comment on any aspect of the proposal.

1. Do you believe the proposal contained in paragraphs 16–29 will improve the accounting standard-setting process for private companies?
2. Specific to paragraphs 16–29 do you believe that the proposed changes will help ensure that the financial reporting needs of constituents of private companies are met?
3. The FASB and the AICPA believe that any differences in generally accepted accounting principles (GAAP) for private companies should be based on financial statement user needs and cost-benefit considerations. Do you agree?
4. The FASB and the AICPA believe that members of the committee (except the chair) should not be compensated beyond a reasonable reimbursement of expenses. Do you agree?
5. The FASB and the AICPA believe the committee should set its own agenda and priorities. Do you agree?

If you would like to nominate a candidate to serve on the committee, please contact Mr. Dan Noll, director of accounting standards at the AICPA, at dnoll@aicpa.org.

Invitation to Comment

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INTRODUCTION

1. The FASB and the AICPA recognize that compliance with GAAP standards for many for-profit private companies is a choice rather than a requirement because private companies can often control who receives their financial information. In many cases, a private company can negotiate with the parties who receive their financial information the type of information provided, the form in which the information is provided, and any disparity from GAAP requirements. Some private companies may comply with GAAP at the request of current or potential lenders, suppliers, customers, or other contracting parties or at the request of state regulators. Other private companies may comply with GAAP because they are funded by venture capital firms with the goal of becoming a public entity. Presumably, the decision by one or more of those parties to require that the financial reports of a private company comply with GAAP instead of another basis of accounting is dictated by the perception of the quality and acceptance of GAAP versus the other available reporting alternatives. Therefore, the FASB and the AICPA recognize the continuing need to ensure that the accounting standards applicable to private companies consider the input of the users, preparers, and auditors of financial reports of private companies.

2. The FASB, the AICPA, and others have periodically studied whether financial accounting and reporting standards should be different for private companies. Until recently, those prior studies indicated that there should not be substantive differences in recognition, measurement, or disclosure solely based on whether a company is privately or publicly held. Some of the reasons frequently cited in opposition to differences in financial accounting and reporting include:

- a. Similar economic transactions and events should be reported consistently regardless of the size or ownership characteristics of the reporting enterprise.
- b. Different financial reporting standards for private companies could result in additional costs to preparers, accountants, auditors, advisors, and others in the areas of continuing education, authoritative resources, and quality control systems.

3. Furthermore, the users of financial reports of private companies have historically been generally supportive of uniform accounting standards for both public and private companies.

4. However, a recent study conducted by the AICPA indicated the support of certain constituent groups (including users) for differences in accounting for private companies.

5. In addition, various international accounting standard setters are exploring ways to provide different financial reporting standards for what effectively are their private company constituents. For example, the International Accounting Standards Board is working on a project to develop accounting standards suitable for entities that (a) do not have public accountability and (b) publish general purpose financial statements for

external users. Also, the Canadian Accounting Standards Board (Canadian ASB) is examining the needs of users of financial statements. Based on the results of that examination, the Canadian ASB will determine and implement the most appropriate financial reporting model to meet those user needs.

THE CURRENT FASB PROCESS IN DEVELOPING ACCOUNTING STANDARDS

6. In developing financial accounting and reporting standards, the FASB is guided by its conceptual framework and its thorough and open due process.

7. The FASB's conceptual framework states that the objective of financial accounting and reporting is to provide information (a) that is useful to present and potential investors and creditors in making investment and credit decisions, (b) that will help users of financial statements assess amounts, timing, and uncertainties of prospective cash flows from their investments, and (c) that informs users about the economic resources of and claims against enterprises, and transactions that affect such resources and claims. The conceptual framework does not provide guidance for whether differences in a reporting entity's size or ownership structure should lead to differences in recognition, measurement, or disclosure.

8. The FASB has long recognized that the information provided in the conceptual framework is a guide for standard setters. However, since users of private company information may have different informational needs, the same information, defined identically, may have a different meaning. For many private companies, the relevant financial statement users include both current and potential lenders, investors, suppliers, and customers. Some users may focus more heavily on an enterprise's ability to meet its debt or performance obligations.

9. The conceptual framework also describes the qualitative characteristics of accounting information. In the hierarchy of accounting qualities, the conceptual framework places **decision usefulness** at the top as the most important quality and **relevance** and **reliability** next as two qualities necessary to provide such usefulness, subject always to the constraints of a cost-benefit consideration.

10. When considering possible differences in the financial accounting and reporting requirements for private companies, the Board has generally differentiated between the financial information that appears on the face of the financial statements and the additional information that appears in the notes to those statements. With respect to the former, the Board has generally concluded that all enterprises, including private companies, should be subject to the same recognition and measurement requirements. That conclusion has been supported in varying degrees by the stated needs of users of financial reports of private companies. On a number of occasions, the FASB has provided deferred effective dates for private companies to alleviate the costs to implement requirements. The most recent example is the alternative measurement provisions and the deferred effective date for FASB Statement No. 123(R), *Share-Based Payment*.

11. With respect to the information disclosed in the financial statement footnotes, the FASB has decided, in some circumstances, to reduce or eliminate the disclosure requirements for private companies. These decisions have generally been the result of input from private company constituents that indicated that the users of financial reports of private companies did not require the disclosure information or that the cost of preparing the information outweighed its benefit to those users.

12. In developing financial accounting and reporting standards, the Board is also required to follow an open and thorough due process. The FASB recognizes that its actions affect many organizations. Therefore, the Board subscribes to a rigorous and open due process that actively encourages constituent input. That process involves public meetings, roundtables, field visits, field tests, liaison meetings, and other vehicles designed to solicit participation and comment. It also includes exposure of the FASB's proposed standards to external review and public comment. Members of the FASB and its staff also regularly meet with a wide range of interested parties to obtain their input and to better understand their views.

13. Many of the FASB's due process activities include active outreach to, and participation by, users, auditors, and preparers of the financial reports of private companies. The FASB makes final decisions only after carefully considering and analyzing the input received from all interested parties.

14. Some of the ways in which the FASB currently attempts to identify the concerns of representatives of private company constituents include the following:

- a. Establishing a Small Business Advisory Committee (SBAC) whose members represent diverse perspectives and experiences and include users who are lenders, investors and analysts, preparers of financial statements from a broad range of businesses, including controllers and chief financial officers, and auditors from small businesses including the private business community.
- b. Ensuring small business representation on the Financial Accounting Standards Advisory Council (FASAC), the Emerging Issues Task Force (EITF), and other project task forces and working groups. The FASAC, as well as the SBAC, are formal parts of the FASB's independent structure, and all have a responsibility to consult with the FASB on technical issues on the Board's agenda, project priorities, and other matters as may be requested by the FASB. The mission of the EITF is to assist the Board in improving financial reporting through the timely identification, discussion, and resolution of financial accounting issues within the framework of existing authoritative literature. Current members of the FASAC and EITF include users, auditors, and preparers of financial reports of private companies.
- c. Participating in liaison meetings with representatives of private companies. The FASB holds annual meetings with several organizations, including the Technical Issues Committee of the AICPA Private Companies Practice Section (TIC) and the Accounting Practices Committee of the Risk Management Association. Additionally, a Board member or FASB staff representative usually participates in TIC meetings. Board members or a representative of

the FASB staff meet with organizations that represent different industry groups who have representation from private companies. Members of the FASB or its staff also have frequent but less formal meetings with other organizations and individuals representing private companies.

- d. Participating at conferences and similar events that are sponsored by or primarily attended by representatives of private companies. For example, members of the FASB or its staff annually participate at dozens of State CPA Society conferences across the country.

15. The FASB process is focused on making technical, rather than policy or legal, judgments. The FASB's mission statement and Rules of Procedure require that in making those judgments the FASB must balance the often conflicting perspectives of various interested parties and make independent, objective decisions guided by the concepts and qualitative characteristics of financial reporting set forth in the conceptual framework.

MODIFICATIONS TO THE STANDARD-SETTING PROCESS TO IMPROVE PRIVATE COMPANY FINANCIAL REPORTING

16. All of the conclusions reached by the FASB result from its open and deliberative process. However, the FASB has not consistently articulated its analysis and consideration of whether differences for recognition, measurement, disclosure, or transition and effective date should exist for private companies, nor has it consistently asked for input on whether differences in those areas should exist for private companies.

17. The FASB and the AICPA are jointly proposing changes to improve and encourage greater input from private company constituents. These changes will assist the Board in determining whether differences should exist within the existing framework of financial accounting and reporting standards of private companies. The objective of the change is not to create a separate, new set of GAAP requirements for private companies.

Changes to the FASB Standard-Setting Process

18. The FASB is committed to continually reassess and improve its processes to develop high-quality accounting standards that meet the needs of its constituents, including those related to private companies. To improve the process for receiving quality input, the FASB intends to implement new procedures to ensure that the financial reporting needs of constituents of private companies are adequately addressed. These process changes include:

- a. The FASB staff will seek input specifically from those involved in financial reporting for private companies, including users, preparers, and auditors. This will provide a better understanding of the effect of accounting alternatives and the potential effect of standard-setting activities on private companies.
- b. During the standard-setting process, the FASB staff will provide the members of the FASB with alternatives for private companies. These alternatives will be based on differences in user needs and cost-benefit considerations.

- c. The FASB will articulate within the basis for conclusions section of standard-setting documents (both Exposure Drafts and final Statements) the basis for its decisions on whether differences should exist for recognition, measurement, disclosure, transition, or effective date for private companies.
- d. As part of the FASB's due process for standard-setting activities on exposure documents, the Board will explicitly request that constituents provide information on the standard's impact on private companies.
- e. Following the FASB's receipt of comment letters, the FASB will analyze and evaluate whether differences are warranted for private companies.

19. To ensure that current and future projects of the FASB have adequate resources to address these changes, the FASB intends to assign staff members with private company financial accounting and reporting experience to current and future projects. The FASB is currently actively recruiting staff with public and private financial accounting and reporting backgrounds. For more information, please see the FASB's website at www.fasb.org.

20. In addition, the AICPA is actively recruiting for a position dedicated to the effort described in this Invitation to Comment. For more information, please visit http://www.aicpa.org/careers/newyork_jobs.htm.

Committee to Promote Constituent Input into the FASB Standard-Setting Process

21. In addition to the proposed enhancements to the FASB's process described in paragraphs 16–18, the FASB and the AICPA have agreed to co-sponsor and co-fund a new committee whose mission is to provide recommendations that will help the Board determine whether there should be differences in prospective and existing accounting standards for private companies. The Committee's recommendations to the Board will be based on user needs and cost-benefit considerations. The recommendations may include differences for private companies in recognition, measurement, disclosure, presentation, transition, and effective dates.

Committee Objectives

22. To achieve its mission, the Committee has three broad objectives.

Objective 1. The Committee members individually serve as a resource to the FASB, its staff, and working groups. Committee member input will allow the Board to understand the impact of alternatives and arrive at decisions that are consistent with the Board's conceptual framework. Those decisions will consider the needs of users while also evaluating cost-benefit information. The Committee will create its own interpretation of user needs and cost-benefit considerations for determining its recommendations to the FASB.

Objective 2. Consistent with the FASB's open public due process, the Committee meets in public to evaluate proposals by the FASB or its working groups. It will

then make formal recommendations to the FASB on those proposals. The FASB will address the Committee's recommendations.

Objective 3. Consistent with the FASB's open public due process, the Committee meets in public to evaluate whether existing standards are providing decision-useful information to users of financial reporting information of private companies in a cost-beneficial way. The Committee will then make formal recommendations to the FASB as agenda requests for changes to existing standards. The FASB will address the Committee's recommendations.

Committee Representation

23. The Committee will comprise 11 noncompensated members, in addition to a compensated part-time chair. These individuals will have broad experiences in financial accounting and reporting. The FASB and the AICPA will jointly select the chair and members of the Committee to ensure there is equal representation of the significant constituent groups affected by financial accounting and reporting standards for private companies. These constituents include users (lenders, investors, and sureties/bonding companies), financial management/owners of private companies, and auditing practitioners who primarily work with private companies. A balanced representation is important to ensure that the Committee considers different perspectives and has the ability to reach a broad base of constituents. Furthermore, since the Committee will provide recommendations on whether differences should exist in financial reporting standards for private companies, it is important that some members have both public and private company backgrounds. The FASB and the AICPA will seek nominations for the members of the Committee from all relevant constituency groups.

Committee Operations—Overview

24. The Committee will set its own agenda and priorities and will meet in public to deliberate, reach conclusions, and make its recommendations to the FASB. The Committee should be allowed a certain level of autonomy.

25. Committee materials and agendas will be made available to the public at www.pcftr.org before each meeting.

26. The Committee will meet 4–6 times per year in person and may meet via telephone conference as necessary.

27. The Committee (a) will liaise with interested constituent groups to obtain a broad base of views on private company financial reporting, (b) may conduct formal, broad-based research to achieve its objectives, and (c) may enlist the help of others, for example, by forming resource groups.

28. The FASB and the AICPA will perform periodic reviews to determine the effectiveness of the Committee's operations.

Staffing

29. The Director of Accounting Standards of the AICPA and the Director of Technical Application and Implementation Activities at the FASB will be responsible for ensuring that the Committee has adequate staffing resources to successfully achieve its objectives.