FINANCIAL ACCOUNTING STANDARDS BOARD

Memorandum

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Project	**Private Company Decision-Making Framework**
Topic	**Guide Deliberations and Decisions**

Purpose

1. The purpose of this memo is to consider proposed changes to the proposed Private Company Decision-Making Framework (guide) resulting from feedback received on the Invitation to Comment (ITC) issued on April 15, 2013. Comment letters on the 2013 ITC have been summarized in memorandum No. PCDMF 2.

Proposed Revisions

Differential Factors (Question 2 of the ITC)

2. Question 2 of the ITC relates to the appropriateness of the six differential factors identified by the PCC and the Board.

   The six differential factors are:

   I. Types and number of financial statement users
   II. Access to management
   III. Investment strategies of equity investors
   IV. Ownership and capital structures

V. Accounting resources

VI. Learning about new financial reporting guidance.

3. Twenty-five of the 26 respondents who answered question 2 agreed that all 6 differential factors are appropriate. One of those respondents suggested that more emphasis be placed on factor IV, ownership and capital structures. Eight of those respondents suggested adding additional differential factors between private and public companies such as complexity of the entity's operations, the size of the entity, regulatory oversight, and confidentiality of financial information.

4. One respondent stated that differential factors II, III, IV were not appropriate. They cited examples of matrimonial matters where there is no access to management. They also stated that factors III and IV often do not apply for private companies.

Staff Recommendation

5. Virtually all of the respondents agreed that the guide identifies the appropriate differential factors between public and private companies. The staff recommends that the PCC and the Board reaffirm their previous decisions regarding the six differential factors.

Question 1
Do the PCC and the Board wish to reaffirm their previous decisions regarding the six differential factors?

Overall Effectiveness of the Guide (Question 3 of the ITC)

6. Question 3 of the ITC asked respondents the following:

> Overall, do you agree that this guide would lead to decisions that provide relevant information to users of private company financial statements in a more cost-effective manner? If it does not, what improvements can be made to achieve those objectives?

7. Of the 24 respondents to question 3, 13 agreed, 6 conditionally agreed, and 5 disagreed that the guide would lead to user-relevant information in a more cost-effective manner.

8. Respondents who conditionally agreed suggested that more emphasis be placed on cost and complexity and/or access to management.

9. One of the respondents who conditionally agreed that the guide would lead to user-relevant information in a cost-effective manner is the Private Companies Practice Section Technical Issues Committee of the American Institute of Certified Public Accountants (TIC). Overall, TIC (CL #33) agreed that the guide would lead to decisions that adequately address cost-benefit concerns. However, the TIC expressed concerns about the necessity of providing quantitative disclosures when a private company applyies an alternative transition method for private companies as mentioned in paragraph 5.3 of the guide.

Staff Recommendation

10. The staff believes that the requirement of quantitative information regarding the adoption of an alternative transition method by a private company should only be considered in limited circumstances where the nature of the amendment to existing guidance affects information that users of private company financial statements find relevant. In making that determination, the staff believes that the PCC and the Board should consider whether the amendment significantly impacts important financial metrics such as reported cash balances, cash flows, adjusted EBITDA, working capital, and total borrowings. Accordingly, the staff is recommending the following changes to paragraph 5.3 (additions are <u>underlined</u> and deletions are ~~struck through~~):

> A private company should be required to disclose in the notes to financial statements if it has applied an alternative transition method. That disclosure should include, at a minimum, qualitative information about how the amendments affect the comparison of its current-period financial statements with its prior period financial statements. ~~Depending on the nature of the amendment to existing guidance~~ <u>In limited circumstances</u>, the Board and the PCC should consider whether

a private company also should disclose quantitative information about how the amendments affect the comparison of its current-period financial statements with its prior-period financial statements. <u>Consideration of quantitative disclosures should be limited to amendments that significantly affect important financial metrics as listed in paragraphs 5.4(a) and 5.4(b).</u>

Question 2
Do the PCC and the Board agree with the staff's recommendation regarding the changes in paragraph 5.3 as indicated above?

Industry-Specific Guidance (Question 4 of the ITC)

11. Question 4 of the ITC asked respondents the following:

    With respect to industry-specific guidance:

    a. Do you agree that this guide appropriately considers industry-specific accounting guidance for private companies? That is, should private companies follow the same industry-specific guidance that public companies are required to follow in instances in which the Board and the PCC determine that the guidance is relevant to financial statement users of both public companies and private companies operating in those industries? If not, why?
    b. Do you think factors other than user relevance, such as cost and complexity, should be considered when the Board and the PCC are determining whether or not to provide alternatives within industry-specific guidance?
    c. Do you think that industry-specific accounting considerations should be different between (i) recognition and measurement and (ii) disclosure?

12. Of the 34 respondents to the ITC, 24 answered question 4(a), 13 answered question 4(b), and 17 answered question 4(c).

13. Thirteen respondents agreed that the guide appropriately considers industry-specific accounting guidance for private companies. Of the 13 who agreed, 7

respondents suggested that cost and/or complexity should be considered in addition to user relevance by the PCC and the Board.

14. Some respondents who agreed with the guide's consideration of industry-specific accounting guidance added that recognition and measurement differences between private and public companies within industry-specific guidance should be rare. However, those respondents were more amenable toward the idea of providing differences in disclosure.

15. Four respondents said that consideration of industry-specific guidance should be no different than the consideration of any other guidance. Two of those respondents represented credit unions that were concerned that the flexibility afforded by alternatives for private companies within U.S. GAAP would be lessened by the rebuttable presumption as written in the guide. National Venture Capital Association (CL #31) stated that consideration should be no different between industry-specific guidance and any other guidance. The National Venture Capital Association suggested that the entire section on industry-specific guidance should be removed from the final version of the guide.

16. Eight respondents disagreed with the guide and added that there should be no differences between private companies and public companies within industry-specific accounting guidance.

Staff Recommendations

17. When considering alternative display guidance for private companies within U.S. GAAP, the guide states that there is a presumption that information that is important enough to be presented on the face of financial statements is relevant to most financial statement users. Therefore, in general, private and public companies should apply the same financial statement display guidance.

18. As the presumption exists for both nonindustry-specific guidance and industry-specific guidance, the staff believes that it is redundant for the PCC and the Board to separately consider industry-specific guidance within the Display module.

Question 3
Do the PCC and the Board wish to remove special consideration for industry-specific guidance within the Display module?

19. Many respondents were more amenable to the idea of providing disclosure differences for industry-specific guidance than for recognition and measurement. As such, the staff recommends that the PCC and the Board add a consideration for cost and complexity in addition to user relevance when considering potential disclosure alternatives for private companies.

Question 4
Do the PCC and the Board wish to add a consideration for cost and complexity in addition to user relevance within industry-specific guidance section of the Disclosure module?

Question 5
Do the PCC and the Board wish to reaffirm their decisions regarding the industry-specific consideration in the Recognition and Measurement module?

Primary Information Needs of Users, Access to Management, and the Red-Flag Approach (Question 5 of the ITC)

20. Question 5 of the ITC asked respondents the following:

> Do the different sections of this guide appropriately describe and consider the primary information needs of users of private company financial statements and the ability of those users to access management, and does the disclosure section appropriately describe the red-flag approach often used by users when reviewing private company financial statements (see paragraphs BC45 and BC46)? If not, why?

21. Overall, respondents either agreed or conditionally agreed with the ITC on access to management and the redflag approach. However, it appeared that respondents

were more amenable toward the idea of providing alternatives in disclosure when compared to the idea of providing alternatives in recognition and measurement.

Feedback on Access to Management

22. Nine of the 22 respondents agreed, another 9 respondents conditionally agreed, and 4 respondents disagreed.

23. Those respondents who expressed conditional agreement emphasized that although access to private companies' management is a differential factor, there might be cases when that access is limited only to certain users.

24. Two of the respondents who conditionally agreed stated that the framework should further emphasize the relevance of the access to the management differential factor.

25. Some respondents disagreed with the guide for a variety of reasons. One respondent stated that access to management should not be considered in determining alternatives for private companies within U.S. GAAP because access to management is not equally available to all users. Another respondent stated that general purpose financial statements should not be modified based on access to management and that it would lead to two separate sets of U.S. GAAP.

Feedback on Red-Flag Approach

26. Seven of the 21 respondents agreed, 11 respondents conditionally agreed, and 3 respondents disagreed with the description of the red-flag approach in the disclosure section of the guide.

27. Among the respondents who conditionally agreed to the appropriate description of the red-flag approach, some indicated that more guidance should be provided for the application of the red-flag approach because the description included in the guide is still broad in scope and open to subjective interpretation.

28. The respondents who disagreed with the red-flag approach were primarily concerned with the fact that access to management is not consistent between users of private company financial statements.

Access to Management in Recognition and Measurement

29. To address the concerns raised by constituents, the staff proposes the following:

View A: Reaffirm the decisions reached on access to management as it relates to the recognition and measurement module. Currently, access to management is considered in deciding whether a recognition and measurement alternative for private companies within U.S. GAAP should be permitted. However, paragraph 1.9 states that access to management should not be a dominant factor in deciding whether to permit an alternative within U.S. GAAP. The guide also states that access to management should be considered in determining recognition and measurement alternatives for private companies within U.S. GAAP.

View B: View B would remove access to management as a consideration in determining whether a recognition and measurement alternative for private companies should be permitted. However, the Board and the PCC would still consider access to management in determining a viable alternative for private companies within U.S. GAAP. View B would require the following changes:

a. Amend paragraphs 1.4 and 1.5 as follows (additions are <u>underlined</u> and deletions are ~~struck through~~):

   1.4 ~~In analyzing benefits and costs, the Board and the PCC should take into account the questions listed in paragraphs 1.5 and 1.6 to the extent each is pertinent to the issue under consideration.~~ <u>In deciding whether to provide recognition and measurement alternatives for private companies within U.S. GAAP, the Board and the PCC should consider the questions listed in paragraphs 1.5 and 1.6</u>. Some of the questions would be most applicable when the Board and the PCC are reconsidering the benefits and costs of existing guidance, while other questions would be most applicable when evaluating new guidance being deliberated for projects on the Board's current agenda.

   1.5 The first group of questions pertains to the relevance of information to typical users of private company financial statements <u>as follows:</u>~~ and the access that those users commonly have to the relevant information, as follows:~~

b. Remove question 1.5(h) from the guide.

~~h. Is it likely that users that are interested in the transaction, event, or balance can obtain information directly from management that can reasonably satisfy the objective of the guidance?~~

c. Amend paragraph 1.9 as follows:

1.9 As the Board and the PCC evaluate potential alternatives for private companies within U.S. GAAP, they should also consider the ability of users of private company financial statements to access management to obtain additional information beyond what is reported in financial statements. ~~Management access should not be a dominant factor in deciding whether to permit an alternative for private companies within U.S. GAAP. Rather, access~~ Access to management should be viewed as a mitigating factor in evaluating cost-benefit considerations, including the risk that some users might find public company recognition or measurement guidance to be more relevant. If the Board and the PCC limit alternatives for private companies to those areas of U.S. GAAP that do not have broad or significant relevance to typical users of private company financial statements, relatively few users are expected to need to access management to obtain the information for which alternatives have been applied.

View C: View C would remove consideration of access to management in the recognition and measurement module. In other words, access to management would no longer be considered in determining whether a recognition and measurement alternative should be permitted. Furthermore, access to management would no longer be considered in determining potential alternatives within recognition and measurement guidance.

Staff Analysis

30. Most respondents agreed that access to management is a differential factor between public and private companies; however, there was mixed feedback in determining the level of consideration in setting recognition and measurement guidance for private companies within U.S. GAAP.

31. Proponents of View A believe that access to management should be considered in determining recognition and measurement guidance for private companies. They also recognize that access to management is not consistent among all users of private company financial statements. Accordingly, they emphasize that access to management should not be a dominant factor in deciding whether to permit an

alternative for private companies. Proponents of View A also believe that access to management should be considered in determining recognition and measurement alternatives for private companies within U.S. GAAP.

32. Proponents of view B believe that the determination of whether there is a sufficient basis for alternative recognition and measurement guidance should not include the consideration of access to management. They believe that this approach would alleviate the concern with placing too much weight on access to management. View B would still allow the Board and the PCC to consider access to management in determining potential recognition and measurement alternatives.

33. Proponents of View C believe that there may not be sufficient consistency of access to management to justify including access to management as a factor in the guide with respect to recognition and measurement. Accordingly, there should be no presumption of access to management in the recognition and measurement module. Some proponents of View C believe that U.S GAAP modified based on access to management would ultimately lead to two separate sets of U.S. GAAP.

Question 6
Do the PCC and the Board wish to reaffirm their decisions regarding the consideration of access to management in the disclosure module?

Question 7
Which view do the PCC and the Board support regarding considerations of access to management within the recognition and measurements module?

Recognition and Measurement Questions for the PCC and the Board (Question 6 of the ITC)

34. Question 6 of the ITC asked respondents to consider whether the following considerations were necessary in considering alternatives for private companies within the recognition and measurement guidance:

> 1.5(e) Does the guidance require the threshold for recognizing or measuring a transaction or event be at least probable of occurring?

> 1.5(h) Is it likely that users that are interested in the transaction, event, or balance can obtain information directly from management that can reasonable satisfy the objective of the guidance?
>
> 1.5(i) Is the lag between the year-end reporting date and the date financial statements are issued and made available to users likely to significantly dilute the relevance of the information resulting from the guidance?

35. Overall, respondents agreed that questions included in paragraph 1.5(a) through (i) were appropriate; although they noted that some questions were more relevant than others. However, 3 of the 23 respondents to question 6 recommended the removal of question 1.5(h), and 8 of the 23 respondents recommended the removal of question 1.5(i) from the recognition and measurement module.

Staff Recommendations

36. The staff believes that the list of questions included in paragraphs 1.5 and 1.6 should not be viewed at as an all-inclusive list to assess benefits and cost for private companies. Ultimately, the PCC and the Board will need to exercise judgement in making user relevance and cost and complexity evaluations. As such, the staff recommends adding the following sentence to the end of paragraph 1.4:

    The questions included in paragraph 1.5 and 1.6 are not all-inclusive and the assessment of benefits and costs requires judgment.

37. In addition, the staff recommends that question 1.5 (i) should be removed from the guide based on feedback received. The staff also believes that consideration 1.5(i) is difficult to apply when determining whether a recognition and measurement alternative should be permitted.

Question 8
Do the PCC and the Board agree with the staff's recommendation to amend paragraph 1.4 and to remove question 1.5(i)?

All or Nothing (Question 7 of the ITC)

38. Question 7 of the ITC asked the respondents whether they agreed that:

    a. A private company should be eligible to select the alternatives within recognition or measurement guidance (elective approach) that it deems appropriate without being required to apply all alternatives available to private companies?

    b. It would be appropriate for the Board and the PCC, in certain circumstances, to link eligibility for application of alternatives within recognition or measurement in one area to the application in another area?

39. An overwhelming majority of respondents agreed with items (a) and (b) above. Respondents who agreed with the elective approach stated that the PCC and the Board did not intend to create a separate set of U.S. GAAP for private companies. Requiring all recognition and measurement guidance to be adopted would, in effect, result in a separate set of U.S. GAAP for private companies. Furthermore, supporters of the elective approach stated that the approach alleviates preparer concerns about the requirement to apply all future private company alternatives without the ability to assess the impact on relevancy of accepting an "all-or-nothing" approach. However, several supporters of the elective approach emphasized the need for appropriate disclosure when financial statements are presented using an alternative recognition and measurement basis within U.S. GAAP.

40. Supporters of the all-or-nothing approach argued that complexity would increase if private companies did not have to apply all of the alternatives for recognition and measurement.

Staff Recommendation

41. The staff believes that the need for disclosure has been addressed within paragraph 1.10 of the proposed guide and recommends that no revisions should be made to the guide in relation to that issue.

42. The staff recommends that the PCC and the Board reaffirm their decision to allow a private company to select the appropriate alternatives within recognition or

measurement and to have the PCC and the Board, in certain circumstances, link the eligibility for application of alternatives within recognition or measurement.

Question 9
Do the PCC and the Board wish to reaffirm their decision allowing a private company to select the appropriate alternatives within recognition or measurement and having the PCC and the Board, in certain circumstances, link the eligibility for application of alternatives within recognition or measurement?

Change in Accounting Principle

43. Based on feedback received, certain stakeholders would like the PCC and the Board to provide private companies with guidance when changing an accounting policy either from or to the permitted alternatives for private companies (that is, how the accounting policy should be determined for private companies that intend to switch from one alternative to another permissible alternative).

44. Topic 250, Accounting Changes and Error Corrections, requires an accounting principle adopted for the preparation of financial statements to be applied consistently when accounting for similar events and transactions. However, an entity may change an accounting principle (that is, adopt a "voluntary change") if it justifies the use of an allowable alternative accounting principle on the basis that it is preferable. Paragraph 250-10-55-1 states:

> …preferability among accounting principles shall be determined on the basis of whether the new principle constitutes an improvement in financial reporting and not on the basis of the income tax effect alone.

Staff Recommendation

45. The staff believes that initial adoption of private company alternatives within U.S. GAAP should not be subject to a preferability assessment. Accordingly, although a private company would be required to disclose which alternative within U.S.

GAAP has been chosen, it would not be required to justify why a private company alternative is preferable to other recognition and measurement alternatives.

Question 10
Do the PCC and the Board agree with the staff's recommendation to not require a preferability assessment upon initial adoption of private company alternatives within U.S. GAAP?

Question 11
Do the PCC and the Board wish to provide guidance on switching from a private company alternative within U.S. GAAP?

Determining the Effective Date of Guidance

46. The proposed guide states that generally, private companies should be provided with a one-year deferral beyond the first annual period required for public companies to adopt new guidance. The guide also states that a private company should have the option to adopt the amendments before the deferred effective date for private companies but no earlier than the required or permitted date for public companies. Furthermore, private companies generally should not be required to adopt amendments during an interim period within the fiscal year of adoption.

Staff Analysis

47. Preparers of private company financial statements said that they primarily learn about new financial accounting and reporting guidance from their public accountants and that those education updates generally coincide with planning procedures of an audit or review of year-end financial statements. Those preparers also stated that their public accountants frequently are not involved in the interim financial reporting process because their users rarely require a review or audit of interim financial reports. As a result, preparers find it extremely burdensome and difficult to implement new accounting guidance during an interim reporting period.

48. Paragraph 47 of this memorandum serves as the basis for the current proposal in the guide. However, some share an alternative view of requiring private companies to adopt new accounting guidance during an interim period as long as the adoption date is at least one year after the effective date for public companies. Proponents of the alternative view believe that a one year deferral provides private companies with sufficient time to achieve significant efficiencies from observing the earlier implementation experiences of public companies—even if the adoption of the guidance is first applied during an interim period.

49. Proponents of the alternative view are most concerned with the fact that interim financial statements could be prepared on a basis that will be different from financial statements prepared at year-end. They believe that this will ultimately increase cost and complexity for both preparers and users. In such cases, a preparer will have to recast financial results presented at an interim period and explain to the users of their financial statements the difference in basis during the interim reporting period and the annual reporting period.

50. Proponents of the current proposal acknowledge the concerns raised, but they argue that the current proposal is more flexible because it already provides a private company with the option of adopting before the deferred effective date. Those proponents believe that the decision to adopt during an interim period or annual period should be left to the preparers and users of private company financial statements. In other words, the cost-benefit evaluation of reporting on an inconsistent basis between interim and annual reporting periods should be left to the preparers and users of private company financial statements.

Question 12
Do the PCC and the Board wish to reaffirm their decision that private companies generally should not be required to adopt amendments during an interim period within the fiscal year of adoption?

Question 13
Do the PCC and the Board wish to address any other issues related to the Private Company Decision-Making Framework?