

Private company financial reporting

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On the agenda again

Private company financial reporting is on the agenda again. On Dec. 17, 2009, the Financial Accounting Foundation (FAF), the American Institute of Certified Public Accountants (AICPA) and the National Association of State Boards of Accountancy announced the creation of a blue-ribbon panel to study the issue of standards setting for private companies. The panel will make recommendations that address a growing concern about the relevance of accounting standards for reporting entities that do not file financial statements with the Securities and Exchange Commission (SEC).

This panel is not the first to address the issue of whether there should be different reporting standards for private companies and public companies, often referred to as “differential reporting.” It has been the subject of extensive discussion over the past four decades, especially at the Private Companies Practice Section (PCPS) of the AICPA and the Private Companies Committee at Financial Executives International (FEI). The AICPA’s PCPS issued a Qualitative Research Study, *Standards Overload: Problems and Solutions*, in June 1995. The Financial Accounting Standards Board (FASB) issued an Invitation to Comment, *Enhancing the Financial Accounting and Reporting Standard-Setting Process for Private Companies*, in June 2006.

Although these groups found support for differential reporting, the overall conclusion was that separate accounting standards would be logistically difficult. The general principle that emerged from these documents was that measurement and recognition would be the same for all entities, but that disclosure may differ based on cost/benefit considerations. Stated differently, accounting would be the same for all types of entities, but financial reporting could differ. Several standards issued by the FASB have incorporated this principle over the intervening years.

The 2006 FASB Invitation to Comment led to creation of the Private Companies Financial Reporting Committee (PCFRC). The PCFRC is sponsored by the FASB and receives additional administrative support from the AICPA. The PCFRC meets regularly to discuss issues of concern to private companies and provide comments to the FASB.

The PCFRC is now taking the lead in putting the issue of private companies back on the agenda. In a letter to the FAF dated Nov. 19, 2009, the PCFRC communicated its unanimous decision to recommend that the FAF consider private company accounting issues in the context of the mission of the FASB. The PCFRC went on to state its preference:

The Committee believes that a separate, stand-alone set of accounting standards for U.S. private companies tailored to the needs of the users of those statements is the preferred approach. However the Committee realizes there could be other major alternatives for private company accounting that should be explored. In establishing standards for private company financial reporting, the needs of financial statement users balanced against the costs of complying with the standards must be an overriding principle.

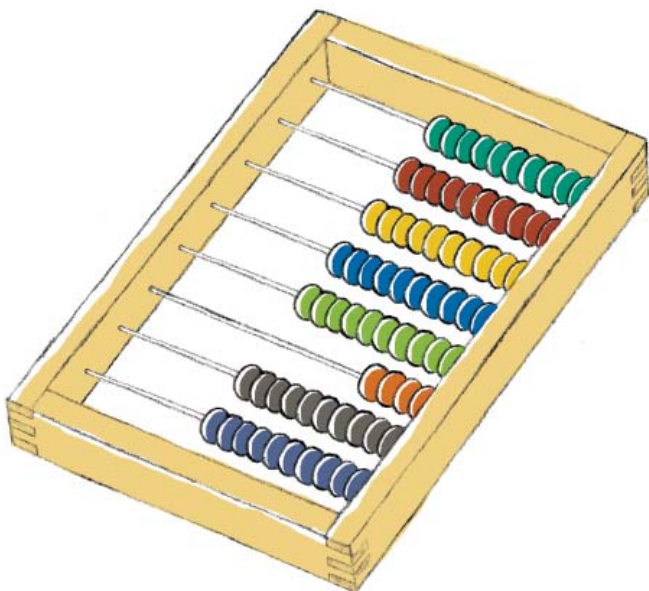
The FAF response to the letter from the PCFRC was swift; the blue-ribbon panel was announced less than a month later.

What is different this time?

Differential reporting has been studied and restudied. What has changed that could lead to a different result this time?

The PCFRC identified four events and trends in the United States and around the world that support a re-examination of private company accounting standards:

- The issuance of the International Financial Reporting Standard for Small and Medium-Sized Entities (IFRS for SMEs)
- Efforts underway in other countries to address private company GAAP (including the recent publication of *Accounting Standards for Private Enterprises* in Canada)
- Recent surveys of financial professionals in the United States that demonstrate a preference for differential accounting standards for private companies
- The increasing number of complicated accounting standards, driven primarily by public company investor and analyst needs. These are often expensive for private companies to implement and provide far less benefit for the users of private company financial reporting.



IFRS for SMEs

The recent issuance of IFRS for SMEs has raised the discussion to a new level. Issued by the International Accounting Standards Board (IASB) in July 2009, IFRS for SMEs is already recognized as GAAP by the AICPA and could be applied by private companies in the United States. Private companies in this context are defined as companies that do not have public accountability. This definition excludes companies with shares listed on exchanges, banks, insurance companies and similar entities.

IFRS for SMEs is particularly significant because it signals an end to the long-established principle that recognition and measurement must be the same for public and private companies. Business combinations, financial instruments, intangible assets and other items have mandatory or optional alternative recognition and measurement requirements as well as reduced disclosure requirements. IFRS for SMEs has legitimized differential accounting.

IFRS for SMEs not only includes a set of “stand alone” standards; it also contains a separate conceptual framework for SMEs. This also is significant because it will allow for a different basis for determining future standards. The IASB appears to be signaling that the objective of financial reporting, and possibly even the definition of an asset and a liability, could differ for private companies. It also could be an indication that the joint IASB/FASB conceptual framework project should be viewed as applying only to companies with public accountability, at least as far as the IASB is concerned.

IFRS for SMEs also firmly establishes the intent of the IASB to move beyond financial reporting standards for global capital markets and to become the standard setter for all for-profit entities. This is an ambitious task that goes far beyond the usual constituencies of IFRS (global financial markets, market regulators and international coordination agencies such as the International Monetary Fund, the World Bank and the Bank for International Settlements). To date, no major economy has adopted IFRS for SMEs so the authority of the IASB for setting standards for private companies is still an unresolved issue.

Canada issues Accounting Standards for Private Enterprises

On Dec. 15, 2009, the Accounting Standards Board of the Canadian Institute of Chartered Accountants made its own contribution to the conversation by publishing *Accounting Standards for Private Enterprises (ASPE)*. Private companies in Canada must choose between applying ASPE or full IFRS for fiscal years beginning on or after Jan. 1, 2011.¹ By issuing ASPE, Canada has accepted the concept of differential accounting for private companies.

The decision by Canada to publish its own standards illustrates how the IASB, despite continued success in establishing its authority over the setting of financial reporting standards for entities with public accountability, has yet to establish its legitimacy as a global standards setter for private companies. Canada rejected IFRS for SMEs while adopting IFRS as the replacement for Canadian GAAP for public companies.

Recent Grant Thornton LLP survey results

Recent surveys indicate that there is more support for differential recognition principles than there has been in the past and that such support may be increasing rapidly. For example, Grant Thornton LLP (Grant Thornton) conducted a survey of senior financial executives from Sep. 21 through Oct. 2, 2009, and received responses from 846 U.S. CFOs and senior comptrollers. A majority (56 percent) of respondents from private companies agreed that there should be **different** recognition and measurement principles for public and nonpublic entities. The extent of support increased to 66 percent, however, when the question was rephrased to ask whether private companies should be allowed to use **simpler** recognition and measurement principles.

Another interesting result was the response to whether private U.S. companies should be allowed to use IFRS for SMEs. In March 2009, only 36 percent agreed. By September 2009, that number had risen to 52 percent. The survey also showed greatly enhanced awareness of the issues.²

Complicated, costly and inappropriate accounting standards

According to the PCFRC letter to the FAF, the crux of the matter is the increasing number of complicated accounting standards. From the perspective of a private company, these standards are often viewed as less than ideal because they are:

- oriented toward the needs of financial analysts,
- expensive to implement (and audit), and
- based on a model of financial reporting that is not a good fit for private companies.

Standards setters today are highly focused on the needs of financial analysts. Analysts focus on highly liquid markets where the equity of a firm may turn over several times a year. For many financial analysts, information needs are driven by computerized trading models designed to exploit short-term market inefficiencies and opportunities for arbitrage. Many strategies rely on identifying very small inefficiencies that can produce large profits when the investment is highly leveraged.

Financial statements responsive to analyst needs are expensive to prepare and expensive to audit. The costs of preparing and auditing financial reports would be less of an issue if the data met the needs of private companies. However, private companies and their users are more often interested in accountability to owners and compliance with bank covenants than valuation of equity securities. The information set useful for trading strategies that take advantage of short-term market inefficiencies is virtually meaningless to private company investors.

The focus on financial markets has also led to a change in the underlying accounting model. Supported by 40 years of financial economic theory and research, there has been a gradual change from a traditional, transaction-based model with a focus on realized income to a more complex valuation-based model with a focus on economic income. What has not been established, through research or otherwise, is which model, the traditional or the financial economic, is a better fit for private companies.

¹ See the Flash Bulletin available from GTI member firm Raymond Chabot Grant Thornton http://www.rcgt.com/wmfichiers/Flash_2009-12.pdf.

² Full survey results are available at www.GrantThornton.com/CFOsurvey.

A changing landscape for accounting and financial reporting

Concerns by private companies over the years have increasingly been driven by gradual changes to the financial reporting model. While these changes have been incremental, ultimately they are altering the very nature of financial statements. The traditional accounting model based on income, performance and accountability has gradually been replaced by a complex financial economic model based on current and future cash flows, with a focus on valuation. The transformation is still incomplete, forcing readers of financial statements to decipher a complex mélange of financial reporting components that are difficult to prepare and audit.

The models, or paradigms, have fundamentally different financial reporting objectives. This is creating differences in interpretations of such basic concepts as relevance and reliability; changing definitions of critical financial statement elements such as assets and liabilities; and dramatically shifting the professional skills required to prepare and audit the financial statements. Understanding these changes and the unresolved issue of their relevance to private company financial reporting is an important first step in appreciating the concerns of preparers and users of private company financial statements.

A different objective of financial reporting

Traditionally, financial reporting has been more about the **content** of the financial statements than the use of financial statements. It was widely understood that financial statements portray the financial effects of past events and that such information could be useful to a wide range of users. The accountant needed to be concerned about completeness and accuracy of the information. Concepts such as **value relevance** and **predictive ability** were just emerging. The objective of financial reporting was similar to what is described by the IASB in its current framework:

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. ... Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it.

All that began to change in the 1970s as accounting theory incorporated elements from financial economics. The fundamental purpose of preparing financial statements began to change. Throughout the 1980s, the changes were incorporated into the FASB conceptual framework, often using language that compromised between the two models. Starting in the 1990s, new standards began to incorporate financial economic theory but not always consistently. The new conceptual framework project seeks to complete the process by removing many of the concepts from the preceding model in the revised drafts. The extent of the change can be seen, for example, in the FASB/IASB *Preliminary Views on the Conceptual Framework for Financial Reporting* issued in July 2006, which exposed a new definition of the objective of financial reporting. The new objective is focused on capital allocation and is therefore closer to the objective of the SEC—to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation—than to the traditional accounting objectives that included stewardship and accountability.

The Preliminary Views document did not include other creditors, such as suppliers, customers or employees, as users of the financial statements. In compromise wording inserted in response to comments received, the subsequent Exposure Draft³ amended the objective in paragraph OB2 to state that “Information that is decision-useful to capital providers may also be useful to other users of financial reporting who are not capital providers.” In addition, stewardship (accountability) initially was not included as an objective of financial reporting but was incorporated into the subsequent Exposure Draft with compromise wording that states “Because management’s performance in discharging its stewardship responsibilities usually affects an entity’s ability to generate net cash inflows, management’s performance also is of interest to potential capital providers who are interested in providing capital to the entity.” The amended wording was not included in the objective but inserted later in the document.⁴ The underlying premise of the revised objective is that information that meets the needs of capital providers is general-purpose financial information. In a comment on the conceptual framework, the European Financial Reporting Advisory Group noted that “Little or no evidence is provided to justify this assertion.”⁵

The Exposure Draft uses a similar premise to justify a single set of standards for both public and private companies: “For entities that do have external users of their financial reports, the objective of the reports issued to them is the same because the information needs of investors, creditors and others who need to make resource allocation decisions about the entity generally are the same.”⁶

What may be more important is that there is a presumption that the purpose of financial reporting by private companies is capital allocation. In a free market economy, capital is allocated by the price mechanism.⁷ The FASB and the IASB are therefore implying that valuation of equity or debt instruments is the objective of financial reporting. But few preparers of financial statements see this as a primary objective. For example, in Grant Thornton’s most recent *Survey of Senior Financial Executives*, only a very small proportion of the respondents (four percent of private company respondents and six percent of public company respondents) indicated that valuation of debt and equity securities was the primary reason that companies prepare audited financial statements. The large majority of private company respondents indicated that their primary objectives were compliance with loan covenants and accountability to owners.

What is the primary reason that your firm prepares audited financial statements?

	Private	Public
To obtain credit and/or demonstrate compliance with loan covenants	35%	6%
To meet the needs of a broad range of users of the financial statements	22%	37%
To provide information on financial position and performance to owners of the firm	23%	27%
To meet other legal requirements	11%	23%
To provide information useful for valuing equity and debt securities of the firm	4%	6%
Other	6%	1%

Percentages may not total 100 due to rounding.
Source: Grant Thornton *Survey of Senior Financial Executives: Fall 2009*

³ Joint IASB/FASB Exposure Draft “An improved Conceptual Framework for Financial Reporting; Chapter 1: The Objective of Financial Reporting; and Chapter 2: Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information.”

⁴ Id, paragraph OB12.

⁵ See, for example, the comments by the European Financial Reporting Advisory Group in its Discussion Paper: “The Conceptual Framework: Starting from the right place?”

⁶ Op cit, paragraph BC1.31.

⁷ In economic theory, the price mechanism is the signal by which scarce resources, including capital, are allocated to their best use in a free economy. By contrast, in a controlled or fixed price system resources must be allocated by other means, including rationing or other non-market intervention.

Dueling paradigms of financial reporting

The revisions to the conceptual framework reflect different models, or paradigms, of financial reporting. There are two widely held points of view on the nature of financial statements, one based on the traditional accounting model and one based on financial economics and capital markets research.

The traditional accounting model was based on legal principles, double entry bookkeeping for transactions and events, and general-purpose financial reporting to meet the needs of a broad range of users. The financial statements show performance (income) and accountability for funds invested. The newer accounting model, based on financial economics, is about capital allocation, which is to say the pricing of equity and debt instruments in capital markets. The role of each financial statement differs in each model.

The traditional accounting model provides financial statements that interpret the results of transactions and events:

- The **income statement** is the key financial statement for assessing future cash flows to investors in the form of dividends or interest (investors are only indirectly interested in the future cash flows of the entity) and evaluating performance using metrics such as return on investment. The guiding principles are income realization and conservatism, as income is intended to be an amount that could prudently, or legally, be distributed to shareholders while preserving the rights of creditors. Gains are recognized when realized, and losses—defined as expenses in excess of revenues—are recognized when incurred.

- The **balance sheet** is a record of investment and financing activity using entry prices, the conversion of resources to goods and services, and the realization and monetization of income (therefore the balance sheet is often a residual).⁸ Because the focus of the model is on realized income rather than economic income, the balance sheet is not expected to reflect current values of individual assets.
- The **statement of cash flows** disaggregates and further explains net changes in the balance sheet by highlighting the sources or uses of cash from operations, investments and financing transactions. The indirect method of preparing the statement of cash flows accomplishes this objective at minimal additional cost.

The financial economic model is a very different interpretation of the financial statements:

- The **statement of cash flows** is the key financial statement for assessing free cash flow and valuing the equity or debt instruments traded in capital markets. The direct method, although more costly to prepare, is the preferred format for valuation purposes. The definitions of operating and financing activities also differ as operating activities assume the guise of free cash flow. The definition of an investing activity is still the subject of debate.⁹ Assets and liabilities are defined in terms of future cash flows instead of legal rights and obligations.

⁸ The balance sheet is primarily but not exclusively at amortized historical cost. Conservatism would indicate that investments that cannot be recovered should be written off or recorded at salvage value. In some cases, the entire balance sheet could be recorded at fair value. Entities now referred to as broker/dealers have accounted for their securities inventories at “mark to market” since about 1700. However, traders were compensated based on closed books (realized profit).

⁹ One characteristic of the shift to a different financial reporting paradigm is changes in the definitions of terms. In many cases the terminology remains the same, but with different meanings. The definitions of key terms such as general purpose financial reporting, investor, creditor, operating cash flows and fair value have all changed, sometimes in subtle ways. The term “professional judgment” is also changing to reflect more emphasis on evaluating future cash flows rather than judgment in terms of the meaning of contractual rights and obligations and realization. The FASB and IASB also plan to change the definitions of assets and liabilities to remove references to past transactions. This can be a source of confusion for accountants educated in earlier years.

- The **statement of financial position** (balance sheet) becomes a forecast of future cash flows of the entity based on exit prices, which are viewed as more relevant than entry prices.¹⁰
- The **income statement** is the residual and, according to Nissim and Penman,¹¹ earnings are uninformative about future earnings and about value; however, income measures periodic shocks to value and thus informs about risk. Performance metrics such as return on investment are not available, therefore, management’s stewardship is measured in terms of value added. Gains and losses are recognized when estimable, using economic valuation models or market prices (which are often based on the same models). Gains and losses include the effects of changes in future cash flows and changes in the rate at which future cash flows are discounted. Future anticipated gains and losses due to a decrease or increase in interest rates are recognized immediately. Gains, therefore, may be recognized prior to realization. Losses that do not meet the definition of an accounting loss may be recognized in the current period and recaptured as superior earnings in future periods. The recognition of both gains and losses serves to normalize future earnings and returns on investment to market rates by adjusting the balance sheet.¹²

The increased relevance of the balance sheet comes at the cost of decreased relevance of earnings. The relative unimportance of earnings is evident in the current project to revise financial statement presentation. The original proposals did not include a “subtotal” for net income; this has since been revised.

The shift to a financial economic paradigm, while not complete, has increased concern among all preparers, but especially those in private companies, about the relevance of the information used in their financial statements. The declining relevance of earnings is not the only concern. There are also reservations about reliability, training and education, and the relative costs and benefits of applying new accounting standards.

Accounting for liabilities

The issue of recognizing changes in the fair value of liabilities helps illustrate how the two models of financial reporting may differ with respect to assessing relevance.

Under a financial economic model, liabilities measured at fair value would decrease in value as a result of a decrease in the credit standing of the reporting entity. The decrease in fair value would be recognized as an increase in comprehensive income.

This result is counterintuitive from a traditional legal perspective. First, the legal amount of the liability may not have changed. Second, the amounts recognized in income could not be prudently distributed to shareholders without harming the interests of creditors. Therefore, the change in the fair value of the liability would not qualify for recognition on either the balance sheet or the income statement.

¹⁰ That relevance can be degraded due to the interval between the date of the valuation and the date of issuance of the financial statements.

¹¹ “Principles for the Application of Fair Value Accounting” by Doron Nissim and Stephen Penman of the Center for Excellence in Accounting and Security Analysis at <http://www.gsb.columbia.edu/ceasa>.

¹² Recently some experts have argued that this feature of financial reporting based on a financial economic model fosters procyclicality.

The changing nature of reliability

The paradigm shift is also changing the nature of reliability in financial reporting. In the current conceptual framework, reliability is on a par with relevance. Reliability comprises two elements: representational faithfulness and verifiability. In the revised Conceptual Framework currently out for comment, reliability has been eliminated and replaced with representational faithfulness alone; verifiability has been downgraded to an **enhancing** characteristic.

These changes are part of a broader shift in the focus of financial reporting from the results of transactions to current values. FASB Statement 157, *Fair Value Measurements*, issued in September 2006, helped introduce this new conceptual definition of reliability for accounting (and auditing) purposes. Statement 157 introduced a multilevel hierarchy of reliability that is a function of market prices, similar market prices or models of economic value (which often drive market prices directly or indirectly). This has significant implications for the skills required to both prepare and audit financial statements. It is becoming more important for accountants and auditors to understand financial economics and the mathematical models used for valuation rather than analyzing transactions to determine whether the amounts have been correctly reported and classified.

The definitions of assets and liabilities may also be changing. The current working definition of an asset is “a present economic resource to which the entity has a right or other access that others do not have.” References to past transactions and events have been removed. Faithful representation is now a measure of the validity of the valuation model and the assumptions used instead of verification of the amounts recorded by comparison to the amounts in supporting documentation of a past transaction.

Reconciling the models using other comprehensive income

The traditional and financial economic models have co-existed in uneasy compromise for the past 40 years.¹³ A key element of that compromise for the past 20 years has been the increased use of other comprehensive income (OCI) to permit a financial economic presentation of the balance sheet, while preserving a traditional accounting presentation of net income. The compromise is unstable because it fails to do either. A good example of this is FASB Staff Position FAS 115-2 and FAS 124-2, “Recognition and Presentation of Other-Than-Temporary Impairments,” which requires impairment amounts related to credit losses (accounting losses) to be recognized in earnings and changes in fair value due to other factors (financial economic losses) to be recognized in other comprehensive income.¹⁴

The fair value hierarchy

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3 inputs are unobservable inputs for the asset or liability.

¹³ Although the debate is often characterized as being between fair value and historical cost, the traditional model is not inconsistent with the use of fair value in certain circumstances. A good discussion of the issues and proposals for when fair value accounting may be appropriate can be found in Nissan and Penman, *op cit*.

¹⁴ http://www.granthon.com/staticfiles/GTCom/files/services/Audit%20and%20Assurance%20services/Assurancepublications/New%20Development%20Summaries/NDS%202009/NDS_2009-19.pdf.

Both the FASB and the IASB have indicated that they would like to do away with OCI. Therefore, there has been no attempt to define either earnings or OCI conceptually and, although OCI is increasingly used in both U.S. GAAP and IFRS, its application remains ad hoc.¹⁵

The process of reclassifying (or recycling) other comprehensive income into earnings on realization is also controversial and adds to the complexity of financial reporting.

Surprisingly, investors have not been actively involved in the debate. When asked to choose between the models, many analysts will request that financial statements be presented from both perspectives because both have information value. Most analysts want to retain net income from the accounting model. The European Federation of Financial Analysts Societies suggests in its comment letter that “amortised cost provides decision-useful information to users as long as reliant (sic) market values are disclosed as well (ideally in a separate column next to the book values) and as long as it is the intention of the company to hold these assets long term.” The CFA Institute proposes “that one approach to address the different information needs of different stakeholders including users, would be to require both fair value and amortised cost reporting for those financial instruments that are eligible for amortised cost treatment, and thereafter to display with equal prominence the gains and losses on those financial instruments on separate income statement columns.”¹⁶

Separate standards for regulatory purposes

Another alternative for reconciling differences between the models is to use different accounting measurements for regulatory purposes. In 1991, following the savings and loan crisis, Congress decided that federal banking regulators should use GAAP as the basis for determining capital adequacy. Regulators retain statutory flexibility for supervision and can (and have) authorized departures from GAAP. In December 2009, FASB Chairman Bob Herz acknowledged in prepared remarks that the FASB had sought middle ground by requiring some unrealized losses to be recognized on bank balance sheets, but not to be reflected on income statements.

Grant Thornton also has suggested that regulatory capital could be separated from U.S. GAAP in a letter to regulators in May 2009.¹⁷ Regulators could adjust capital requirements in response to different economic environments, providing “dynamic regulatory capital provisioning.” This would enable investors to have the information they need (GAAP), while providing regulators the tools to properly monitor financial institution safety and soundness.

¹⁵ See, for example, the response to IASB Exposure Draft 2009/7 from the World Bank (Comment Letter 59) for a discussion on the conceptual basis for other comprehensive income: “We also note this project, like some others, appears to utilize Other Comprehensive Income (OCI) as a parking lot for undesirable volatility. It is difficult to see whether the use of OCI in this proposal results in improved financial reporting because an overall principle for what should be in profit and loss and what should be OCI has never been articulated.”

¹⁶ See, for example, the responses to IASB Exposure Draft 2009/7 from Securities Analysts Association of Japan (Comment Letter 8), the European Federation of Financial Analysts Societies (Comment Letter 150) and from the CFA Institute Centre for Financial Market Integrity (Comment Letter 226).

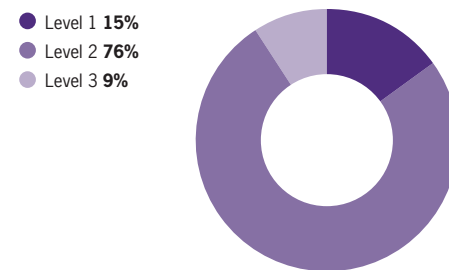
¹⁷ http://www.GrantThornton.com/staticfiles/GTCom/files/GT%20Thinking/CommentLetters/Additional_Comments/Fair%20value%2005.05.09.pdf.

Implications for preparing and auditing financial statements

The change in the financial reporting paradigm is the most significant change in the accounting skill set since the introduction of double entry bookkeeping. Michael Power, professor of accounting at the London School of Economics and Political Science, observes in a forthcoming paper that “the intellectualization of financial reporting in the shadow of financial economics is not just a matter of technical measurement – it is a blueprint for redesigning the knowledge base of an entire profession.”¹⁸ Previous core competencies based on accounting conventions are being replaced by valuation techniques. Finance, economics and physics are replacing business law and double entry bookkeeping as the core competencies of accountancy.

Auditing fair value measurements is not as simple as comparing recorded amounts to published market values. For example, the SEC in a recent study of the causes of bank failures¹⁹ found that about 45 percent of the assets of failed banks were recorded at fair value. Of those assets, only 15 percent of the financial assets measured at fair value fell into Level 1 of the fair value hierarchy; 76 percent of the assets measured at fair value were measured using Level 2 inputs; and nine percent were measured using Level 3 inputs. The portion measured using unobservable Level 3 inputs could increase to a majority of a financial institution’s assets if future standards require loans to be measured at fair value. Extensive disclosure requirements for those measurements would increase the complexity of preparation and auditing.

Classification of assets measured at fair value at failed banks
As of first quarter – 2008



Source: SEC’s Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting

¹⁸ Fair value accounting, financial economics and the transformation of reliability by Michael Power.

¹⁹ Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting.

Costs and benefits

A financial economic model based on fair values (exit values) imposes additional costs on all financial statement preparers. Frequent revaluation on an annual or quarterly basis adds to the complexity of preparing and auditing financial statements. Private companies that may not be able to afford to have in-house valuation expertise are compelled to hire external experts or to consider changing from GAAP to another basis of financial reporting. Regardless of the relevance of this information, it is invariably more expensive.

The cost of preparation is less when the information is already accumulated and used for management purposes. The incremental costs may include those associated with increased demands for precision, documentation and auditing. When the information is not used for management purposes, the entire cost of preparing and auditing the information would be incremental.

Many of the benefits of this additional information accrue to the designated users of the financial statements, i.e., investors in liquid or highly liquid capital markets. The average holding period for many equity securities is now less than three months so there is a premium placed on constant revaluation of the company to match the perspective of the short term investor.

The average investor at a private company has a much longer time horizon for measuring return on investment. Unless the users of the financial statements at private companies place a similar premium on frequent current information, the costs of frequent revaluations resemble a dead weight loss to the reporting entity and the owners of the enterprise.

The average users of the financial statements may not even be able to appreciate the more costly information. According to Grant Thornton's *Survey of Financial Executives*, a significant majority (73 percent) responded that financial statements are too complex to be usable by the average investor.



PCFRC Roadmap: possible future models

Based on concerns with the direction of financial reporting and its appropriateness for private companies, the PCFRC developed five possible options for proceeding with alternative standards when the SEC proposed its own roadmap for transition to IFRS. The first three are based on IFRS, and the last two are based on U.S. national standards:

- IFRS as GAAP in the United States for all companies (public and private). Private companies would have the option to use IFRS for SMEs or another comprehensive basis of accounting.
- IFRS for SMEs adapted to meet the needs of private companies in the United States
- IFRS modified by additions or deletions to meet the needs of private companies
- Current U.S. GAAP reviewed, modified and developed into a comprehensive and self-contained set of accounting standards for private companies
- Current U.S. GAAP maintained, as is, for use by private companies.

More recently, members of the PCFRC and the FEI Committee on Private Companies have proposed a conceptual approach. Rather than trying to build off of either IFRS or U.S. GAAP, a conceptual approach would favor developing a separate conceptual framework for private companies. If previous projects are any indication of the level of effort involved, this could be a daunting task that would involve considerable time, effort and resources. The Financial Accounting Standards Committee of the American Accounting Association prepared a report titled “Alternative Conceptual Framework for Financial Reporting” that provides an example of a different approach to a conceptual framework based on transactions and income.²⁰

The IFRS model already has a separate conceptual framework for SMEs (based on the existing *Framework for the Preparation and Presentation of Financial Statements*). It is too soon to evaluate whether IFRS for SMEs will address the concerns of private companies. Any move to create a separate U.S. GAAP for private companies will need to both establish the legitimacy of the standards and obtain the resources necessary to publish and maintain them.



²⁰ Electronic copy available at: <http://ssrn.com/abstract=1441338>.

Grant Thornton comments

In our response to the Invitation to Comment, *Enhancing the Financial Accounting and Reporting Standard-Setting Process for Private Companies*, Grant Thornton LLP supported changes to the standards-setting process that would assist the FASB in determining whether there should be different recognition, measurement, disclosure, presentation, transition and effective dates for private companies. The firm's response also supported the creation of the PCFRC.

In regard to the financial reporting model, Grant Thornton International Ltd and Grant Thornton LLP expressed concerns over the transition to a model of financial reporting exclusively focused on investors and creditors (in a joint Nov. 3, 2006 comment letter responding to Preliminary Views, *Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information*). While their interests are very important, an exclusive focus on the needs of investors and creditors understates the importance of financial reporting.

Grant Thornton LLP and Grant Thornton International Ltd also previously commented that cash flows should not be the exclusive focus of financial reporting. The premise put forward by the FASB and the IASB in the proposed revisions to the Conceptual Framework that investors and creditors have a common interest in the ability of an entity to generate future cash flows does not support the Boards' conclusion that cash flows should be the primary focus of financial reporting. It is more accurate to say that one of the purposes of general purpose financial reporting is to help users make assessments of an entity's future cash flows.

On the issue of separate accounting for private companies, Grant Thornton LLP and Grant Thornton International Ltd agree with the FASB and the IASB that the objective of general purpose external financial reporting should be the same for all entities, but has expressed concerns that overemphasis of the needs of investors and creditors for capital allocation is not consistent with that determination. In the 2006 response to the Preliminary Views, Grant Thornton LLP and Grant Thornton International Ltd commented that the proposed changes in the objective of financial reporting would encourage calls for a separate financial reporting framework for non-publicly accountable entities and that "on balance we believe that the proposed financial reporting objective is unsuitable for smaller, privately held entities."

The objective of capital allocation could be viewed as a special case that is a subset of a more general objective of financial reporting that is common to public entities, private entities, not-for-profit organizations and government. A different approach, therefore, to developing an objective of financial reporting would be to look first at the general case and the objectives held in common and then address the specific information needs of investors and creditors. As the FASB and the IASB have acknowledged, those needs may extend beyond the boundaries of financial reporting. Therefore, Grant Thornton LLP welcomes the establishment of the blue-ribbon panel to study the issues facing private companies and urges that the scope be expanded, if possible, to include the interests of not-for-profit organizations. While the best outcome perhaps would be a single objective and a single set of standards for all entities, the unique needs of the global capital markets and their importance may indicate that a different set of standards for investors and creditors in those markets may be the best solution to meet their needs. Other standards, more reflective of accountability and local legal considerations, may better address the needs of private companies and not-for-profit organizations.

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John Hepp is a partner in the National Professional Standards Group. Hepp started his professional career in the National Office at Grant Thornton LLP focusing on accounting and auditing issues, including computer-assisted auditing and statistical sampling applications. Hepp spent several years working overseas in Europe, Asia and Africa on accounting and auditing policy matters and professional regulation, including curriculum development and continuing education design. His current role includes monitoring of accounting developments under both U.S. GAAP and IFRS. He provides consultative services to Grant Thornton LLP and its clients on U.S. GAAP and IFRS-related issues. He is based in Chicago.

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