Private Company Accounting: A Concept Whose Time Has Come

By Vincent J. Love

The Perspectives section of the December 2010 *CPA Journal* included an article, "IFRS for SMEs: Not for Private American Companies" by Natasha Herman, that contained conclusions concerning private company financial reporting that cannot be left unanswered. The article posits that we should not establish or recognize accounting standards for private companies that would be different from those applied to public company financial reporting, that is, companies required to register and file reports with the SEC. The reasons given to support the position taken can be broadly categorized as follows: 1) acceptability, 2) comparability, 3) impact on education, 4) dilution of expertise, and 5) the incurrence of unnecessary and redundant expense. Under each of these categories are reasons why it would be a mistake to have two sets of standards. I respectfully disagree with this position and with every argument in support of it presented in the article.

Acceptability

There are over 5.5 million businesses in the United States that employ one or more individuals other than the owner. There are approximately 17,000 companies registered with the SEC. Privately owned companies represent the bulk of the American economy. Over the years, as new and more complex standards have been added to GAAP and investors' objectives have changed, the need for information based on current U.S. GAAP of users of private company financial statements have begun to differ greatly from those of SEC registrants.

These differences in the needs of financial statement users have become more noticeable over the past few years. The average holding time for a security has declined significantly, reflecting a change in the character and investment objectives of the holders of equity securities. The change in the holding period of equity securities traded on the New York Stock Exchange (NYSE), arguably the exchange trading the highest overall quality of equity, is indicative of this change in investment philosophy. In 1960 the average holding period was 100 months, after which the holding period steadily declined to 12 months currently, based on 2010 data through April. (Basic data used are from www.nyxdata.com/nysedata/asp/factbook/viewer_interactive.asp.)

Equity securities have become less of an investment vehicle and more of a trading medium. The investor holding an equity security for a short period of time has a greater need for knowing the exit value of an enterprise when making an investment or trading decision. Consequently, fair value financial information is more important than historical cost–based data, the traditional financial accounting basis for financial statement valuation.

On the other hand, a private company financial statement user has other needs more effectively addressed by simpler, less costly reporting standards. The owner needs data to manage the business or evaluate management (stewardship), assess cash flow and future cash requirements, assess return on investment, and raise money through borrowing from lending institutions. Additionally, if the owner-manager or manager needs the entity's financial statements to make business decisions, they are not properly managing the business. Business managers have key statistics that they can use to gauge the business's activities long before financial statements are published.

Lenders need financial statements to assess an entity's ability to service its debt. In the case of a collateralized loan, the lender will perform its own evaluation of the expected cash liquidation value of the loan collateral. Vendors would have the same concerns as the lenders—payment of amounts owed for the good or services delivered—but in a much shorter time frame than the lender. Consequently, fair value accounting is not as important to the user of private company financial statements, even as its use is appropriately increasing for financial reporting under both GAAP and International Financial Reporting Standards (IFRS)—the standards used for reporting by SEC registrants.

Lenders evaluate a prospective borrower from the point of view of loan repayment. The criteria for assessing repayment are known as the three (or four) C's of credit—cash flow, capital, collateral, and sometimes the character of the borrower. A lender expects to be paid out of cash flow from operations. If cash is not available from operations, the lender looks to the capital of the company that is free and can support repayment. Only as a last resort does a lender look to liquidate collateral, and, if it is a secured loan, the lender will do its own evaluation of the collateral and not rely on financial reporting fair value. Moreover, a lender does not want to perfect a lien on collateral and become an owner and seller of the collateral. A lender wants to have its loan repaid with interest.

An owner of a private company needs to evaluate his return on investment, not a return on fair value. When evaluating management, since the company—unless it is a securities firm—usually is not trading its productive assets, the exit value of the company is not important. It becomes important only if the company is up for sale and then most often an advisor is consulted to determine the value of the company when shaping the negotiating strategy. If someone wants to acquire the company, they will perform the necessary due diligence and evaluate the business and its assets and liabilities, regardless of what standards are used for financial reporting. In essence, there is no daily, quarterly, or annual need by the user of private company financial statements for the same financial information applicable to SEC registrants. Investors in companies whose equity and debt trades daily on an exchange, however, need to evaluate exit value periodically to make a reasoned investment or trading decision. Private company accounting, which does not include significant and complex standards that are more appropriate for SEC registrants, will be acceptable to users of those financial statements.

Comparability

Relevancy, not comparability, is important to users of private company financial statements. Relevance will be the key characteristic sought, especially when it comes with a much lower price tag and greater understandability. In making an investment decision, financial statements of SEC registrants will be compared to each other in every case except where a sophisticated and active investor (investment partnerships and individuals with access to analysts and other data sources) wants to take a position in a private company if it is up for sale. Why compare a private company financial statement to a public company statement? Shares of public companies or publicly traded debt instruments can be acquired or sold on an active exchange at any time and in any quantity. The comparison that needs to be made is between or among two or more public companies. Why should the accounting and financial reporting needs for approximately 17,000 entities that issue publicly traded securities trump the needs of the estimated 5.5 million private entities that are important to our national economy, but whose equity or debt is not publicly traded?

The author states, "Under IFRS for SMEs, the latter [private companies earning billions in yearly revenue] would use different accounting treatment than comparably sized public companies for similar transactions simply because of their status as private entities. This is neither logical nor in the interest of financial statement users." What is illogical about it? Large private companies' equity interest or debt is not being bought or sold on a daily basis. If either investment vehicle is, then it needs to use the more extensive GAAP or IFRS reporting standards. When the regular investor cannot purchase an interest in one of two companies, why does she need to compare their financials? If an investor has the assets to acquire all or a portion of a private company, she (or, if an enterprise, it) can and will perform the necessary due diligence. This is not a usual daily activity. The lender and vendor are interested in the ability of the entity to repay its debt or pay for the goods and services it received, not how it performs vis-à-vis other companies in its space. It is logical and in the interest of the financial statement user to have relevant information and not, in the case of the vast majority of users of private company financial statements, irrelevant and difficult to compile and understand information.

Impact on Education

The underlying bases of the differing standards will be the same. The differences will be in addressing the needs of users. Accept the fact that there are different needs for different users of financial statements. The one-size-fits-all, common-user financial statement is dead—killed by the technology that gave birth to complicated business transactions and financial instruments but also to exponentially greater speed and capacity. Two major groups of users are those who invest through acquisitions of securities on public exchanges and those who own or invest in private enterprises. Representational faithfulness will remain the guiding principle in recording the economic event. The financial reporting will change based on whether the user needs such information as the fair value of the asset or liability, or the disclosure of analytical data on pensions and other postretirement benefits, that may never be an issue for a user of private company financials. When it is, the information then can be determined and disclosed, for example, by a due diligence review, or by recasting the prior years' financials to conform with the requirements to file with the SEC and become a public company, or by consolidation with an SEC registrant when acquired. Spend the entity's resources when it is needed—not based on what could, but in most cases will not, happen.

> **There are very real differences between the needs of users of financial statements.**

Students will learn the underlying principles and, just like the study of law, can apply those principles in different jurisdictions after researching the application most appropriate. Alternatively, students can specialize in one or the other of the standards and only gain a general understanding of the others. Educators will have to adapt to the changing and challenging business environment, not the other way around. The business environment has and will continue to affect what is taught in universities. Universities have always come up to the challenge and performed admirably. They will again in establishing different curricula to meet the needs of business.

Specialization is not a bad thing. Accountants who had taken basic courses have later specialized and gained knowledge in different industries and different standards for years. With the continuing complexity of business and the speed at which transactions occur, all a product of rapid electronic development, specialization has become a necessity in many areas of the profession. Internal accountants have dealt with changing regulatory requirements and different reporting in certain regulated industries. In companies with foreign subsidiaries, accountants initially trained in GAAP are now preparing or analyzing IFRS-based financial statements and converting them to GAAP for U.S. reporting purposes. The independent auditors for these entities are doing the same.

Students can learn all of the different standards that can and will apply in the immediate future. Information technology allows an individual who is only familiar with a general subject to obtain the necessary information to competently apply the ancillary principles related to the basic subject. The educational institutions will adapt and successfully educate students.

Dilution of Expertise

There will be no dilution of professional talent caused by establishing different standards for SEC registrants and private companies. More focused talent will be developed. Additionally, competent professionals will take the time, make the effort, and do the research needed to address the issues related to having the different standards. They have done it in the past, they are doing it now, and they will do it in the future. Accounting has always been changing, albeit at a slower pace in the past than it is now, and there has been no dilution in expertise. We have different standards now. What is changing?

Unnecessary and Redundant Expenses

I have not seen a cost analysis that compares the costs of requiring private enterprises to prepare statements on a GAAP basis versus adjusting GAAP to private company financial statement users' needs. However, because the cost associated with various new GAAP standards, especially fair value accounting, is presumed to be high in relation to its benefits for the private company financial statement user, it is likely that the use of differing standards will result in significant overall savings for the vast majority of private enterprises. The choice of standards also affects the costs associated with compiled and reviewed financial statements.

In those infrequent instances when financial statements using the simpler standards need to be recast for private companies desiring to go public, the cost should be incurred as part of the changed business circumstance. Overall, companies collectively will have net savings if private company financial reporting is simplified in a set of new standards to make it more understandable and relevant to users' needs.

Moving Forward

Change is always challenging. Accounting needs to change and free itself from the old conventions that may have served it well in the past but now need to become more closely aligned with a different, more dynamic business environment. Twentieth-century concepts need to be reviewed, tested, and conformed to the highly charged and information-based technological environment in the 21st century.

There are very real differences between the needs of users of financial statements. The two largest distinct groups of users are those who purchase and sell securities publicly on exchanges and those who have an ownership interest in a nonpublic enterprise. Relevance is important to the financial statement user in each group. Comparability between the two groups is not an essential element of analysis, given the different venues of the enterprises in each group. Finally, a private company needs relief from the cost of complying with ever more complicated standards that have relevance to companies with publicly traded securities but no relevance to their needs in operating their companies. Change for legitimate reasons is good. The profession and the universities are up to the challenge. ❑

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