PRIVATE COMPANY FINANCIAL REPORTING, GAAP ALTERNATIVES, AND STRATEGIC CONSIDERATIONS OF ADOPTING U.S. GAAP

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SUMMARY: Many private entities, while not legally required to publish financial statements, choose to apply U.S. Generally Accepted Accounting Principles (GAAP) issued by the Financial Accounting Standards Board (FASB). Collaboration between the Private Company Council (PCC) and FASB has resulted in a number GAAP alternatives designed to reduce the costs and complexity of applying U.S. GAAP, while preserving financial information usefulness to private company stakeholders. GAAP alternatives continue to evolve and include recent guidance in responses to the COVID-19 pandemic. Private entities considering adopting U.S. GAAP should strategically consider their future financing needs, organizational structure, expansion opportunities, and available resources.

Keywords: Private company financial reporting, GAAP alternatives, Private Company Council, strategic considerations.

INTRODUCTION

In the U.S., private companies significantly contribute to the economy, the community in which they operate, their employees and families, and other stakeholders; thus, they play a vital role in our society. During the past few decades, the number of private companies has continued to increase, while the number of public companies continued to decline (Henderson, 2019). Private companies vary considerably in size, organization, and legal structure. For example, many private companies operate in a local environment, are solely managed by their founders and may see little growth over time. Others operate in a national or global environment and expand rapidly through venture capital financing. In addition, public companies frequently start their life cycle as private entities, some growing into multi-billion-dollar concerns, prior to "going public."

In the U.S., only public companies legally are required to publish financial statements. These companies must comply with U.S. GAAP and are subject to complex Securities and Exchange Commission (SEC) regulation and reporting rules. Privately-held companies may choose U.S. GAAP or another basis of record-keeping and internal reporting; such as cash basis, tax basis, International Financial Reporting Standards for Small and Midsize entities (IFRS for SMEs), or apply the AICPA's *Financial Reporting Framework for Small and Medium-Size Entities*. However, while not legally required, many private companies prepare financial reports consistent with U.S. GAAP. This decision may be motivated by strategic considerations or contractual obligations.

U.S. GAAP is complex and the provisions of individual standards may be costly to disseminate and apply. For decades, private entities have requested that authoritative standards be issued or existing standards be tailored to the needs of private company financial statement preparers and their financial statement users, avoiding the complexity and sometimes reduced relevance of public company GAAP. While to date, private GAAP does not exist in the U.S., the FASB's collaboration with the PCC resulted in several GAAP alternatives issued specifically for private companies.

Furthermore, FASB and the PCC continue to consider and address financial reporting issues on their agenda. Recently, FASB has issued standards updates and guidance addressing reporting concerns arising from the global COVID-19 pandemic.

This paper is organized as follows. The first section presents background information on private company financial reporting. The following section provides an overview of GAAP alternatives for private companies issued to date by FASB with collaboration of the PCC. In addition, recent projects, as well as FASB's response to COVID-19 are summarized. The last section explores the reasons why privately-held companies may utilize and benefit from using U.S. GAAP and discusses strategic considerations of entities deciding whether to choose to report under U.S. GAAP.

BACKGROUND

Private companies represent a significant portion of the U.S. economy and employ a significant number of U.S. workers. Private companies vary considerably in size--some are small family-run businesses, some are midsize, and some are quite large, employing thousands of workers. A recent study (Kobe & Schwinn, 2018) found that in 2014, small businesses with less than 500 employees, contributed approximately 44% of the U.S. GNP.

During the last decade, the number of privately-held companies has increased continually, while the number of public companies has decreased steady. Currently, there are less than 5,000 public companies, a significant decrease from the mid-1990s, when more 8,000 U.S. companies were publicly listed. (Henderson, 2019).

Since its inception in 1973, FASB has served as the primary independent source of U.S. GAAP. FASB's mission "…..is to establish and improve financial accounting and reporting standards to provide useful information to investors and other users of financial reports and educate stakeholders on how to most effectively understand and implement those standards" (FASB, n.d). Its mission statement appears to embrace all entities that are providing information to investors and other stakeholders.

For decades, private companies have questioned the relevance and costs associated with disseminating, implementing and applying complex provisions of U.S. GAAP and questioned the benefits of the generated information to their financial statement users. Various solutions were proposed over time, from separate grounds-up private company GAAP to modifications to existing GAAP (Mastracchio, 2017).

U.S. GAAP is complex and even its codified version still comprises thousands of pages of authoritative text. Moreover, recent accounting standards updates (ASUs) published by FASB are quite voluminous. For example, ASU No. 2014-09 (codified in topic 606) *Revenue from Contracts with Customers* spans more than 700 pages, including several appendixes.

On May 23, 2012, the Financial Accounting Foundation's (FAF) board of trustees approved the creation of the PCC, which serves as an advisory council to the FASB. The board's final report specified that the PCC should consist of nine to twelve members, appointed by the FAF. PCC members are not remunerated, serve for an initial three-year term, and may be reappointed for an additional term (FAF Board of Trustees, 2012).

The PCC's primary responsibility is to identify possible modifications and exceptions to current U.S. GAAP specifically for private companies and make recommendation to FASB on accounting and reporting issues currently on FASB's active agenda (FAF Board of Trustees, 2012). In addition, the PCC may also make recommendations on current GAAP provisions. The PCC meets quarterly and conducts extensive outreach to stakeholders.

As its first major initiative, the PCC in collaboration with FASB, developed the *Private Company Decision-Making Framework--A Guide for Evaluating Financial Accounting and Reporting for Private Companies*, which was published on December 23, 2013 (FASB PCC, 2013). The purpose of the framework is to serve as a foundation that helps FASB and the PCC decide on alternatives to GAAP that will benefit private company financial statement users and preparers. Possible alternatives to GAAP considered by FASB and the PCC are subject to due process and extensive stakeholder outreach and input. Currently, the board consists of 11 members; in addition, one of the seven FASB board members serves as liaison on the PCC; the current chair of the PCC is Candice Wright.

GAAP ALTERNATIVES FOR PRIVATE ENTITIES

To date, the PCC has endorsed five standards that resulted in new ASUs issued by the FASB specifically for private companies. These ASUs are integrated into the FASB Accounting Standards Codification (ASC) and provide private entities with the choice to adopt GAAP alternatives that are not available to public companies. The five ASUs listed in chronological order, are as follows:

- ASU No. 2014-02—Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill (a consensus of the Private Company Council)

- ASU No. 2014-03—Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach (a consensus of the Private Company Council)

- ASU No. 2014-07—Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements (a consensus of the Private Company Council)f

- ASU No. 2014-18—Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination (a consensus of the Private Company Council)

- Update 2016-03—Intangibles—Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance (a consensus of the Private Company Council)

FASB issued each of the new standards in collaboration with the PCC and in response to feedback from users, preparers, and auditors of private company financial statements. The common objective of each standard is to alleviate some of the costs and complexities of existing U.S. GAAP provisions that are burdensome to private company preparers and auditors without the related information generating benefits to users that exceeded the cost of providing the information.

ASU-2014-02 — Accounting for Goodwill

U.S. GAAP requires that companies reporting goodwill on their balance sheet must at least annually test goodwill for impairment; this typically is a costly and time consuming process. Feedback received by the PCC in response to outreach to private company financial statement stakeholders found that costs associated with accounting for goodwill under existing GAAP outweighed the benefit of the related information. Furthermore, financial statement users indicated that they typically do not consider goodwill and goodwill impairment as part of their financial statement analysis.

ASU No. 2014-02 allows private entities to elect an alternative for existing and future goodwill acquired in business acquisitions. Private companies that choose this GAAP alternative, do not need to annually assess goodwill for possible impairment; instead impairment assessment is required only if a "triggering event" suggests a "more likely than not" chance that goodwill may be impaired. If private companies that adopt the alternative identify a triggering event, they may then choose to either (1) conduct qualitative assessment or (2) proceed to full impairment testing based on (a) an entity or (b) a reporting unit basis.

Furthermore, companies that adopted the private company alternative under ASU 2014-02 need to amortize goodwill on a straight-line basis over a maximum of ten (10) years (FASB, 2014a). In comparison, public companies and private companies that choose not to adopt the alternative, currently may not amortize goodwill. Hence, this alternative treatment provides private companies with the opportunity to virtually avoid complex and often very costly assessment of goodwill, without diminishing the usefulness of goodwill-related information to financial statement users.

ASU-2014-03 — Interest Rate Swaps

Under U.S. GAAP, variable/fixed interest rate swaps are considered derivatives, with the related assets or liabilities reported on the balance sheet at fair value. To mitigate the potentially resulting income volatility associated with including changes in fair value in income, U.S. GAAP permits the use of hedge-accounting, which is quite complex to apply. The PCC's outreach to private entities found that private entities often have difficulty meeting the complex requirements and conditions for hedge accounting and thus frequently are unable to apply this income-volatility reducing accounting method.

ASU-2014-03 allows private companies to utilize cash flow hedge accounting and measure the interest rate swap at the loan settlement value rather than fair value. The related loan settlement value typically is easier to determine than fair value; thus, this alternative reduces the complexity of applying hedge accounting and reduces associated costs for private companies (FASB, 2014b).

ASU 2014-07—Variable-Interest Entities Consolidation

Consistent with U.S. GAAP, a lessee who is the lessor's primary beneficiary must apply Variable-Interest Entity (VIE) guidance and as a consequence, must consolidate the financial statement information of the lessor entity with its own, thereby creating one reporting entity. Feedback from private company financial statement users indicated that they tend to eliminate the lessor entity's results from the lessee's consolidated financial statements. Consistent with this feedback, ASU 2014-07 permits private entities to choose not to comply with VIE guidance and thus avoid the need to consolidate the lessor's financial results with those of the private company beneficial lessee (FASB, 2014c). Hence, this private company alternative will tend to make it easier for private company financial statement users to analyze the company's results and reduce the complexity and costs for private companies choosing the alternative.

ASU 2014-18—Identifiable Intangible Assets in a Business Combination

U.S. GAAP requires that an entity acquiring a controlling interest or significant influence in another company must identify all assets and liabilities and measure them at fair value. If the acquisition results in a controlling interest, the acquiring entity also must report such assets and liabilities in its consolidated financial statements. Feedback from private company financial statement preparers and users suggests that the cost of measuring and reporting such assets separately, as required under U.S. GAAP, likely would exceed the benefit of the information to financial statement users (FASB, 2014d).

ASU 2014-18, provides private companies with an alternative treatment for identifiable intangible assets that (1) are acquired in a business combination, or (2) relate to an investment accounted for under the equity method, or (3) are associated with a fresh start reorganization. Private companies adopting the standard are not required to separately identify and measure "(1) customer-related intangible assets unless they are capable of being sold or licensed independently from the other assets of the business and (2) competition agreements" (FASB, 2014c, summary). The standard further stipulates that companies that adopt this alternative, must also adopt the ASU-2014-02 "goodwill alternative," which requires amortization of goodwill over a maximum of ten years. As a result of this combined treatment, customer-related intangible assets will automatically be included in the goodwill residual and amortized.

ASU 2016-03—Effective Dates of GAAP Alternatives

FASB ASUs typically indicate the effective dates by which provisions of new standards must be adopted. Although, private company alternatives are optional, ASU 2014-02, 03, 07, and 18, included effectives dates, as well as permitting early adoption prior to those dates. The effective dates for ASU 2014-02, 03, 07, and 18 typically were the fiscal period following the issuance of each standard. Feedback from private company preparers indicated that they may not be able to elect an alternative by the standards' effective dates. Some of the common reasons cited were limited resources, timing, and unawareness of the opportunity to choose an alternative (FASB, 2016).

Consistent with stakeholder feedback, ASU 2016-03 removes the effective dates from ASU 2014-07, 02, 03, 18. This allows private companies to adopt the standards subsequent to the standards' initial effective dates. ASU 2016-03 concurrently eliminated the requirement for companies choosing private company GAAP alternatives to conduct potentially costly "preference assessments" prior to adopting the alternative. A preference assessment required that private entities wishing to adopt a GAAP alternative after the related standards' effective date needed to show that the alternative was "preferable" to the current accounting treatment, whereas preferable was interpreted as resulting in improved financial reporting. Furthermore, ASU 2016-03 allows private companies that choose the goodwill-related alternative to treat the ensuing change prospectively, rather than requiring costly retrospective restatements (FASB, 2016).

Recent PCC-FASB Projects and Response to COVID-19

In November 2019, FASB issued a new standard that provides for longer implementation periods for certain complex accounting standards for private, not-for-profit, and small public companies. Under the new standard, those entities are granted two additional years (instead of one) for adopting standards dealing with complex issues relating to leases, credit losses on financial instruments, and hedges (FASB, 2019).

On September 21, 2020, FASB issued an exposure draft entitled, "Revenue Recognition—Practical Expedient for Private Company Franchisors" (FASB, 2020). This exposure draft (proposed ASU) would allow private franchisor companies to treat initial franchise services as a single bundled performance obligation, rather than requiring them to conduct a costly analysis to identify separate obligations and subsequently allocate contract fees to each identified performance obligation. This could yield significant cost savings for private companies who under current GAAP would have to identify and allocate initial costs to several performance obligations, in some cases recognizing the related revenue over time.

While FASB and the PCC have made progress to lessen private companies' burden of reporting under U.S. GAAP, additional issues remain under active consideration for future accounting alternatives; these are shown on the PCC topics webpage. The PCC continues to meet quarterly, discussing projects on FASB's technical agenda, identifying accounting issues to be considered in the future, and addressing currently relevant issues. For example, during its recent meeting on September 22, 2020, the PCC discussed issues relating to (1) Borrower's Accounting for Debt Modifications and Troubled Debt Restructurings, (2) Interim Impairment Testing of Nonfinancial Assets, (3) Accounting for the Paycheck Protection Program, and (4) Accounting for Inventory Impairment" (PCC Meeting recap, 2020).

The global pandemic has created many issues, including accounting issues affecting private business entities. FASB and the PCC are actively exploring opportunities to assist both public and private entities in response to the COVID-19 crisis. In June 2020, FASB issued ASU 2020-05, which delays the required implementation of ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606) and ASU No. 2016-02, Leases (Topic 842) for entities that have not yet implemented these standards or issued financial statements reflecting the implementation (FASB, 2020). This delay specifically benefits private entities, which were required to adopt the standards during the current year.

FASB also is working closely with the AICPA on COVID-19 related accounting support; this includes guidance for companies' accounting and reporting of governmental support programs, such as the Payroll Protection Program (PPP). Consistent with FASB guidance, recipients of the PPP should initially record a liability in the amount of the funds received. Any amount forgiven, should be recognized as a gain from extinguishment of debt, as loan forgiveness is granted (Tysiac, 2020). The PCC requested that FASB provide additional educational materials for private companies struggling with COVID-19 related accounting issues (PCC, 2020).

STRATEGIC CONSIDERATIONS AND BENEFITS OF USING U.S. GAAP

Private companies are not required to issue financial statements consistent with U.S. GAAP. However, some private companies may voluntarily choose to comply with U.S. GAAP; others may enter into contractual agreements that stipulate the use of U.S. GAAP. The decision of whether to apply U.S. GAAP with or without private company alternatives should include consideration of current and future strategies with respect to financing need and preferences; organizational structure, potential national and global expansion plans through acquisitions and de-acquisition strategies, and availability of resources.

Financing Needs and Sources of Financing

Private companies generally do not enjoy the same degree of access to large-scale financing sources as do public entities. Issuing corporate bonds or publically available stock requires full application of U.S. GAAP and compliance with SEC regulation, as well as incurring significant costs and requiring expenditure of considerable resources. While private companies are not required to issue U.S. GAAP statements and comply with SEC regulations, if they seek large loans, their lenders may require that they present GAAP-based financial statements. Furthermore, investors in privately-held companies frequently require GAAP-based financial reporting.

In a two-part video series (FAF, n.d.), representatives of FASB, the PCC, and NASBA, highlighted key reasons why privately-held entities apply U.S. GAAP and may benefit from that choice. According to Daryl E. Buck, former FASB member, GAAP-based statements typically are needed if a company seeks outside capital through large loans or venture capital. Bill Atkinson, past chair of the PCC and NASBA and board member of a privately-held company emphasized that the advantage of using GAAP is that it is perceived as a consistent set of authoritative standards and enjoys recognition as a disciplined basis. Even if U.S. GAAP-based financial statements are not required by lenders, presenting GAAP-based statements may result in lower cost of capital (FAF, n.d.).

In addition to borrowing, private companies may raise needed capital through equity offering. This strategy may require that companies present accounting information consistent with U.S. GAAP. The SEC provides exceptions for private companies allowing them to raise large amounts of capital, without following costly and complex public company registration requirements. For example, under SEC regulation "D" Rule 506(b), section 4(a)(2) of the Securities and Exchange Act, private companies may raise capital from an unlimited number of "accredited" investors, as well as a maximum of 35 non-accredited investors. Form D, which must be filed and is publicly available in the SEC EDGAR data base, must include selected financial information consistent with U.S. GAAP (SEC, n.d.). Furthermore, if any securities are sold to non-accredited investors, private companies must provide them with the same financial information that would be required for a non-exempt equity offering (SEC, n.d.). Thus, a private entity that may currently or in the future raise large amounts of capital through exempt equity offerings should consider adopting U.S. GAAP.

Private entity funding through exempt equity offerings is quite significant. A recent study by a long-term member of the SEC's Division of Economic Risk and Analysis (Bauguess et al., 2018) found that private capital funding exceeded public offerings during the 2009-2017 period. For example, during 2017, 37,785 non-public offerings raised $1.8 trillion in new capital under the SEC Regulation D exemptions; of those entities, 12.4% reported revenue of less than $1 million (Bauguess et al., 2018).

Organizational Structure

Many public companies start their life cycle as private entities. If a start-up private entity plans to become public at a future date, using U.S. GAAP from the beginning will tend to be advantageous. Initial public offerings (IPO) and subsequent financial statement filings require GAAP-based information for several prior years. Thus, setting up the accounting information system under U.S. GAAP from the beginning will be more efficient and not require subsequent changes at a time when staffing and IT resources are needed for IPO preparation.

Even those companies that plan to remain private and are not planning on raising capital under exempt SEC offerings, may contractually be required to use U.S. GAAP. According to Diane Rubin, PPC member, partnership agreements and especially those including limited partners, frequently require that the company utilize U.S. GAAP. Ms. Rubin further stated that even small family-run businesses may feel more comfortable with U.S. GAAP (FAF, n.d.).

Growth Opportunities, Acquisitions, De-acquisitions

Many private companies grow and prosper over time. The use of U.S. GAAP likely may help in evaluating and comparing investment opportunities. Furthermore, private companies receptive to friendly buy-outs or mergers, may benefit from using U.S. GAAP as it will enhance their comparability and lend credibility to the financial information provided.

U.S. GAAP is globally known for its rigor and GAAP standards are developed through an authoritative highly structured process. Financial reports prepared under U.S. GAAP tend to increase comparability not only for investment opportunities, but also in a competitive acquisition market. Companies that wish to sell a product line or division may benefit from using U.S. GAAP and being able to present this information to potential buyers. As stated by George Beckman, member of the PCC, "GAAP lends credibility" (FAF, n.d.).

Resources

Private companies should consider the costs associated with reporting under U.S. GAAP in addition to complying with other record-keeping and reporting requirements, such as compliance with the Internal Revenue Code. Initial accounting information system development and future system changes incur significant costs. Using U.S. GAAP from the inception, may be most efficient in the long-run. In addition, accounting staff who are knowledgeable about U.S. GAAP may already be available in the company and their knowledge can be invaluable as financing strategies, organizational structure, and expansion opportunities evolve. Thus, a company that may need to raise large amounts of capital in the future, may consider acquiring or being acquired by another entity, or change its organizational structure or ownership may benefit from using U.S. GAAP.

CONCLUSION

Persistent demand for private company GAAP has led to the creation of the PCC, which serves in an advisory function to the FASB. The FASB-PCC collaboration has resulted in several GAAP alternatives that provide some relief from the difficulty and cost of applying complex GAAP provisions. Additional private company GAAP alternatives that benefit both financial statement preparers and diverse stakeholders likely will be forthcoming. Newly established and existing private entities considering adopting U.S. GAAP with or without private company alternatives should consider current and future funding needs, potential changes in organizational structure, competitive opportunities, and availability of resources. Using U.S. GAAP will help provide the needed information for private companies to access significant funding sources and may enhance competitive growth opportunities.

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