NASBA

May 3, 2011
TO: State Board Presidents, Chairs, Members and Executive Directors
FROM: NASBA Executive Committee
RE: Standard Setting for Nonpublic Entities

The Board of Trustees of the Financial Accounting Foundation recently announced the formation of a Trustee Working Group to address the important topic of accounting standard setting for nonpublic entities. As a first step in the process to look at one component of this issue, the FAF created the Blue Ribbon Panel on Standard Setting for Private Companies, sponsored jointly with the American Institute of Certified Public Accountants (AICPA) and the National Association of State Boards of Accountancy (NASBA). The Panel concluded its work in January 2011. The establishment of the Working Group is the next phase of the FAF's review of the adequacy and effectiveness of the Financial Accounting Standards Board's (FASB) efforts in setting standards for the private company and non-profit sectors in the United States.

The Working Group is conducting outreach to stakeholders in various ways, including roundtable meetings, surveys, and meetings with advisory and constituent groups and others. In conjunction with obtaining input on the scope of the issues and concerns to be addressed, the Trustees also will seek input on suggested improvements, including the solutions recommended by the Blue Ribbon Panel. To insure that NASBA leadership is giving an accurate portrayal of the Boards' position on this topic, we will be discussing it at the 2011 Regional Meetings. As background for those discussions, we have attached excerpts from the majority and minority positions of the Blue Ribbon Panel members.

BLUE RIBBON PANEL MINORITY POSITION

The State Boards of Accountancy have continued to carefully review the draft models, structures and related information resulting from the Blue Ribbon Panel (BRP) meetings to date. We have not reached the same conclusion as the BRP majority. Nor did the Federal Institution Regulatory Agencies (representing the National Credit Union Administration, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision), the Great American Insurance Company[1], and BRP members Terri Polley, Dev Strischek and Teri Yohn.

Changes are needed in U.S. accounting standard setting, but such changes must address the increasing complexity of accounting standards, the relevance of financial statement information to users and the increasing costs to comply with today's accounting standards. These issues have been decried in this BRP process, but why they only apply to private companies has not been substantiated. It's our view that complex and irrelevant accounting standards must be reined in for both private and public entities.

[1] See responses to BRP survey

In the U.S. today, about 15,000 public companies registered with the Securities and Exchange Commission have evolved from about 26-29,000,000 private entities -- and they have used a common set of accounting standards to measure profits and net worth. This is a public policy issue: The U.S. cannot have two parallel accounting standard setters. Financial statements must reflect the underlying economics of transactions consistently and with a common conceptual framework and measurement.

<u>Users Have Not Protested</u>

In these BRP meetings, we have not heard a strong outcry from financial statement users that differential accounting standards are needed. In response to the BRP's survey questions, the Federal Financial Institution Regulatory Agencies wrote: "The staffs are very concerned about potential approaches that would establish two or more sets of accounting standards for U.S. public and private companies, primarily because of the high probability that such standards would produce materially different results from a recognition and measurement perspective."

The negative consequences of differential accounting standards would far outweigh any benefits to the stakeholders. Such anticipated fallout would include:

(a) Absence of comparability among entities within industries and as entities mature from one reporting sector to another,

(b) Incremental costs of dual accounting standards-setting bodies and processes,

(c) Added strain and costs to users, practitioners, preparers, educators, students and regulators, and

(d) Bifurcation of the accounting talent pool in all sectors.

<u>Confidence in the FAF</u>

Separate accounting standards are not the answer, and an additional separate accounting standard-setting body is not justified. We support a single U.S. set of accounting standards with enhancements or exceptions for private entities as to disclosure and financial reporting, but generally not as to measurement (the BRP's Model 2A).
The expansion of the FASB to seven board members, including a sufficient number to affect private entity influence, is an appropriate first step, as is the immediate need for dedicated and effective FASB senior staff to support accounting standards development, implementation and interpretation. We have confidence that the Financial Accounting Foundation (FAF) will ensure its appropriate and consistent oversight, including private entity influence both in fact and in appearance.

As an independently funded body, it is very important from a public confidence and protection standpoint that the FAF step up its leadership of the FASB, as it was designed to do. Further, it must both establish and maintain the strategy, fairness and consistency of the accounting and financial reporting rules promulgation process which is supported by a conceptual framework. If this is not properly accomplished, ad hoc changes to financial reporting standards will continue, public confidence will be diminished and added governmental intervention could occur. Such concerns have been continually expressed, by the State Boards of Accountancy and others, about the IFRS standard setting prospects through the IASB. Thus, the FAF's mission is key to the ultimate conclusions reached by this Panel. We support the FAF and believe it has begun to demonstrate its intent and ability to facilitate change.

We support U.S. GAAP, for both private and public entities, together with minimal, but allowable, exclusions or enhancements as to disclosure and financial reporting -- but few, if any, differences as to measurement. Such standards development must be supported by a vibrant, dedicated private entity work stream within the FASB, together with FASB member recognition of the importance of this sector. The objectives are to avoid differential standards by separate standard-setting bodies and to utilize the existing structure, which we believe can be successfully adjusted.

<u>Other Possible Services</u>

It should be noted that in private entity situations where various forms of assurance, other than audited financial statements, are possible, it is incumbent on users to consider the benefits and acceptability of such alternative forms of assurance, as opposed to the rigors and costs associated with audited financial statements. In many cases, more cost effective alternatives to an audit exist which are sufficient to meet the user's needs and should be considered.

<u>Standard-Setting at the Crossroads</u>

Everything we recommend can be done now. There is no need to wait 2-5 years and risk uncertainty of the establishment on another board that may, or may not, seamlessly improve private company standards.

Both the FASB and the SEC now need to focus on standard setting with a new dimension of consideration. The SEC on October 29, 2010 released a progress report on its work plan for the consideration of incorporating International Financial Reporting Standards. The public, including users, preparers and practitioners, must understand the outcome of accounting standards applications and no timeline for major changes has yet been announced. Whether, when and how the current financial reporting system may be transitioning to a system incorporating IFRS is still under debate. Once the SEC determines its next course of action, the landscape in which private company standards are set may change significantly.

BLUE RIBBON PANEL MAJORITY VIEW

(Excerpted from January 2011 BRP report on www.fasb.org)

New Board

The supermajority view of BRP members is that the current FASB and even a restructured FASB cannot produce the needed exceptions and modifications to GAAP for private company financial reporting. Those BRP members believe that throughout its history, the FASB has been geared, in its composition and its processes, very heavily toward public companies, with exceptions and modifications in GAAP for private companies too rare and extremely difficult to achieve, especially in areas other than disclosure—that is recognition, measurement, and presentation. Members of a board with authority to set accounting standards for private companies must possess the perspective of those stakeholders, and the FASB cannot be sufficiently restructured or possess enough of the essential private company representation needed to set GAAP for private companies. A new board is the most realistic path forward in overcoming the systemic issue related to the relevance of GAAP for private companies.

PROS AND CONS CONSIDERED FOR THE BRP RECOMMENDATIONS

The BRP considered the following pros and cons in its deliberations to arrive at the recommended model and structure:

Pros:

- A GAAP-with-exceptions-and-modifications model:
- Can be achieved more quickly than some of the other models considered
- Maintains a significant degree of consistency and comparability between public and private companies compared with other models considered
- Minimizes the costs to private companies that choose to "go public" compared with other models considered
- Avoids confusion and system complexity from two highly divergent sets of U.S. GAAP
- Has lower education and training costs than other models considered.

A separate private company board:

- Could provide appropriate structural separation from the pressures that the FASB faces in addressing the needs of public company stakeholders, including the SEC
- Could better address the different needs of private company financial statement users given a targeted focus on one constituency.

Cons:

- A GAAP-with-exceptions-and-modifications model might not be perceived as being sufficiently responsive to complexity and cost issues for private companies (compared with, for example, a separate, self-contained set of private company standards).
- Since the pace of standard setting is often driven (or perceived to be driven) by SEC/ public company sector needs or concerns, a GAAP-with-exceptions-and-modifications model probably affords less opportunity for the standard setter to keep the pace of standard-setting activities to a level that facilitates participation by the private company sector (which generally has fewer resources) in the standard setter's due process compared with other models considered.
- Depending on the extent of exceptions and modifications made by the new board, the result could be substantially different accounting standards for private companies resulting in a lack of comparability, and additional costs and strain to some in the U.S. financial reporting chain. Once a separate board is given authority over private company standard setting, there may be limited ability to stop any such divergence.

• Two boards having authoritative responsibility for an overall, single-GAAP model is unproven and has not been used in other countries.

• It could make engagement in due process inefficient and even confusing for stakeholders that are interested in both public and private companies, and it could possibly undermine the authority of one or both boards.

• Additional funding sources will be required.

The BRP considered the various pros and cons and placed more weight on some factors than on others. The general consensus was that although some models had appeal in the long term, the recommended model has the advantage of achieving needed relief in the near term without adding significant complexity or comparability complications. The BRP also believed that, with a clear mission for the new board, proper coordination of the board with the FASB, and appropriate oversight of the board by the FAF, at least some of the cons would be mitigated.

CONCLUSION ON BRP RECOMMENDED MODEL AND STRUCTURE

In light of the frustrations expressed about the lack of relevance of some GAAP standards and the complexity and rapid pace of change in GAAP by many private company preparers and CPA practitioners in the written public submissions and elsewhere, and because of the length of time needed to achieve the various end-state models, the BRP recommends the U.S. GAAP model with exceptions and modifications for private companies, set by a separate private company board. The BRP believes that this model and structure would be the most effective approach to improve relevance of standards and to get relief for private company stakeholders in the near term. The BRP acknowledges that a two-board structure has risks (as noted above) but firmly believes that through proper coordination and effective two-way communication, the two boards will be able to set appropriate standards that best meet the needs of users of private company GAAP financial statements in a cost-effective manner.

The BRP also recognizes that the FAF or the new board could consider a succession (evolution) of models as a longer-term solution.

V. ADDITIONAL BRP RECOMMENDATIONS: SHORT-TERM, TRANSITIONAL, AND OTHER

Short-term and Transitional Actions by the FASB and the FAF

While the BRP firmly believes that significant change is urgently needed and encourages the FAF to take prompt action to implement the Panel’s recommendations on model and structure, the Panel recognizes that the Trustees will need time to vet the recommendations, especially concerning the creation of a new board, both internally and publicly, and, if the Trustees concur, to then put a new board into place. In light of this, the BRP recommends that the FAF and the FASB take, or in some cases continue to take, certain actions that can be implemented in the short term or can be transitional actions to achieve needed near-term relief for private companies and help ensure a successful transition to the model and structure that the Panel recommends. The BRP believes that these actions, in whole or in part, do not change its recommendations for fundamental changes or the urgency needed to enact them.

Those recommendations are:

1. The FAF should fill at least one of the currently open board positions with individuals who have primarily private company background and experience.[12]

2. The FASB should continue to work closely with the PCFRC or another similar dedicated work stream. It should continue to have one or more board members present at each PCFRC meeting. PCFRC recommendations on Exposure Drafts and other matters should be discussed specifically at open FASB Board meetings.

3. In the short term and continuing as transitional actions until a new board is in place, the FASB should perform the following:

• Continue to hold separate private company roundtables for major projects at locations around the country.

• Incorporate private company concerns expressed at roundtables and in comment letters in the ongoing projects to evaluate whether there should be differences in recognition, measurement, presentation, disclosures, and/or effective dates. In view of publicly expressed concerns, if the board decides that there should be no differences, a clear explanation of their reasoning should be included in the basis for conclusions section of the final standards.

• Consider a delay for private companies in the effective date of major new standards, especially those issued in connection with the FASB-IASB Memorandum of Understanding (MOU) projects, that is longer than the now-routine one-year delay.[13]

These processes described above will most likely continue once the new board is in place but will be led by and/or significantly involve the new board.

4. The BRP recommended that differences in GAAP for private companies be based on a framework (set of decision criteria). Using what it has learned from the two recent roundtables on private company issues with existing GAAP standards as key input, the FASB should begin to articulate “what differentiates private companies from public companies.” This articulation would be used to create the differential framework for private company accounting. The framework would be used to determine whether differences for private companies should be approved. The FASB Board and staff could do much of this work, perhaps with the assistance of an appropriate, broad resource group, even before a decision by the Trustees on a desired model and board structure is finalized. The broad resource group should include significant user representation. If and when a new board is established, it could then complete this work or, if already completed, could review it and either ratify it or revise it.

5. The FASB should look at the public comment process in its standard setting and consider taking steps to make it simpler to encourage responses by a broad base of stakeholders.

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[12] The BRP acknowledges that on January 14, 2011, the FAF announced the appointments of two new FASB members, one of which has substantial experience as a private company CFO and the other of which has substantial experience as a user of financial statements, including financial statements of private companies.

[13] The delay would be with respect to the public company effective date. Thus, if, for example, the effective date for a particular MOU project is 2014 for public companies, this recommendation would contemplate an effective date of 2016 or later, rather than 2015, for private companies.