An Overview of the PCC’s New Private Company GAAP Exceptions

For most private companies, U.S. accounting standards have become overly complex, costly to be in compliance, and are often geared to address the risks and needs of public companies. As a result, the private company community urged the Financial Accounting Standards Board (FASB) to provide some sort of relief for private companies. The relief came in the form of the Private Company Council (PCC).

In May 2012, the Private Company Council (PCC) was established to 1) work jointly with the FASB to agree on a set of criteria to decide whether and when U.S. GAAP alternatives are warranted for private companies, and 2) advise FASB on the appropriate accounting treatment for private companies for items under active consideration of the FASB’s technical agenda. For background on the creation of the PCC, refer to the sidebar on the next page.

The goal of the PCC is to issue standards within a year or less after a decision is made to pursue an accounting alternative, which is very efficient in comparison to the existing process. Although this goal was achieved with the issuance of a number of standards, it’s uncertain if the PCC can continue such momentum as recent topics have been met with much debate and most of the “low hanging fruit” have been addressed with the recent accounting standard updates.

The PCC’s Process
To achieve the desired objectives, the PCC reviews existing U.S. GAAP to identify standards that require reconsideration for private companies. To assist with this review, the PCC considers comments made by the private company community through various public meetings, opinion letters, and its own assessment (including consultation with FASB). Upon consideration of each topic, the PCC proposes an alternative U.S. GAAP treatment for private companies that must be approved by a two-thirds vote of all PCC members. These alternatives can come in the form of modifications or exceptions.

Upon approval by the PCC, alternatives are submitted to the FASB for a decision. If endorsed by FASB, then the proposed modifications will be exposed for public comment (similar to the current standard-setting process). Following receipt of public comment, the PCC will consider changes to the suggested alternative and take a final vote. If approved, the standard is then submitted to FASB for a final decision.

If FASB does not endorse the proposed or final modification or exception, FASB’s Chairman is required to provide to the PCC Chair, within a reasonable period of time, a written response describing the reasons why it was not endorsed (including possible changes for the PCC to consider that could overturn the earlier decision).

The PCC alternatives only relate to private companies; public companies are not allowed to apply them. In the past few months, FASB issued Accounting Standards Update (ASU) 2013-12, Definition of a Public Business Entity – An Addition to the Master Glossary to define a public company specifically as it relates to applying the revised standards. In its simplest form, the standard defines a public company as an entity that is required by the SEC to file or furnish financial statements with the SEC, or does file or furnish financial statements with the SEC.

Recent Private Company Developments
FASB has issued several U.S. GAAP alternatives for private companies. The alternatives are issued as ASUs and include the phrase “(a consensus of the Private Company Council)” in the title.

The alternatives allow private companies to apply these standards to their financial statements, which would still be in accordance with U.S. GAAP. All three alternatives allow for early adoption, which many companies utilized in their 2013 financial statements. However, a calendar year 2014 or 2015 implementation date was included in the standards. Each standard requires certain disclosure considerations so the user understands which alternatives are applied.

The alternatives are elections and, as such, are optional; once an election is made, opting in and out would need to be justified in accordance with existing guidance on changes in accounting policies and would be applied retrospectively.
Goodwill

FASB ASU No. 2014-02, Intangibles – Goodwill and Other (Topic 350): Accounting for Goodwill permits a private company to subsequently amortize goodwill on a straight-line basis over a period of 10 years, or less if the company demonstrates that another useful life is more appropriate. Goodwill is the residual asset recognized in a business combination after recognizing all other identifiable assets acquired and liabilities assumed.

This amortization approach to goodwill is consistent with the pre-2001 guidance issued back in 1971. It also permits a private company to apply a simplified impairment model to goodwill, which allows for testing at the entity or reporting level.

The 10-year life is consistent with what was included in International Financial Reporting Standards for Small- and Medium-Sized Entities (IFRS for SMEs) and was considered by the PCC. The guidance does not follow tax laws (currently, 15 years) as such laws could change in the future. A 10-year life would allow for a similar amortization period of separately identifiable intangible assets that would potentially allow grouping of similar assets into goodwill (an issue currently being addressed in the PCC’s identifiable intangible asset project).

As noted, a 10-year life is the maximum, although justification could be made for a shorter useful life given the nature of the business (e.g., technology or heavy reliance on a particular contract).

Interest Rate Swaps

FASB Accounting Standards Update No. 2014-03, Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps – Simplified Hedge Accounting Approach gives private companies (other than financial institutions) the option to use a simplified hedge accounting approach to account for interest rate swaps that are entered into for the purpose of converting variable-rate interest payments to fixed-rate payments.

Under current accounting rules, it’s complicated and costly to qualify for hedge accounting treatment; one of the many requirements includes an annual ineffective test. This alternative allows for hedge accounting for these types of swap arrangements and enables the volatility of the hedge instrument to remain out of the income statement and recorded through other comprehensive income without having to comply with the rigorous rules/tests and disclosures of the original standard.

Variable Interest Entities

Under current U.S. GAAP, a company is required to consolidate an entity in which it has a controlling financial interest. The assessment of controlling financial interest is performed under either a voting interest model or a variable interest entity (VIE) model. In a VIE model, the company has a controlling financial interest when it has 1) the power to direct the activities that most significantly affect the economic performance of the entity, and 2) the obligation to absorb losses or the right to receive benefits of the entity that could be potentially significant to the entity.

To determine which model applies, a company preparing financial statements must first determine whether it has a variable interest in the entity being evaluated for consolidation and whether that entity is a VIE.

FASB Accounting Standards Update No. 2014-07, Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements allows a private company to elect, when certain conditions exist, not to apply VIE guidance to a lessor under common control and thus consolidation is not required. Instead, the private company would make certain disclosures about the lessor and the leasing arrangement.

PCC Background

In December 2009, the AICPA, the Financial Accounting Foundation (FAF, FASB’s parent organization), and the National Association of State Boards of Accountancy (NASBA) formed a blue-ribbon panel to address how accounting standards can best meet the needs of private company financial statement users.

The panel’s ultimate goal was to provide recommendations to the FAF on the standard-setting process for private companies. After much consideration, it was decided that FASB should continue to govern this process, but that special considerations should be made for private companies, where appropriate.

In May 2012, the panel recommended and the FAF approved the establishment of the Private Company Council (PCC). There are currently 10 members on the PCC who are private company practitioners (4), and users (3) and preparers (3) of financial statements.
These types of relationships are very common in the construction industry. For example, let’s say a construction company owner has a related company that owns tangible assets (typically a building, vehicles, or equipment) and leases exclusively to the operating company.

Under the original standard, most of these types of transactions would require consolidation, which was not the intent of the owner or its lender. The alternative allows for private companies to exclude such activity from their financial statements and only disclose the nature of the related party leasing arrangement.

**Developments Under Construction**

In addition to ongoing collaboration of active projects with FASB (some of which have been issued recently), the PCC is currently deliberating a number of topics that were identified in their look back review.

A brief summary of some of the significant ongoing projects follow. (*Author’s note:* This list is not comprehensive as revisions are made periodically based on recent developments. Please refer to the PCC and FASB websites listed a few pages ahead for active discussions, including summaries of recent public forums addressing the various topics under consideration.)

- **Revenue Recognition** – Released in May 2014, this standard allows for the continued use of percentage of completion for long-term contracts. For more information, visit CFMA’s Revenue Recognition Hub at www.cfma.org/revenuerecognition.

- **Identified intangible assets** (noncompetes, customer related intangible assets, etc.) – This project addresses the need to carve out certain identifiable intangible assets as part of the purchase allocation of an acquired business.

Currently, the PCC states that an intangible asset exists if there is a discernible cash flow that indicates the intangible asset is capable of being sold or licensed independently. Given the current definition, certain assets that are currently treated separately (e.g., customer relationships and noncompete agreements) would now be included as a component of goodwill and amortized accordingly.

If adopted, this modification should reduce the need for formal valuations and accordingly lead to lower compliance costs. At the PCC’s July 15 meeting, this project was discussed and the FASB staff was directed to conduct research for discussion at a future meeting.

- **Lease Accounting** – The PCC is working directly with FASB on this project, which has been met with much criticism. Opponents argue that the current model is fine and that the primary reason was in the interest of convergence, which has since subsided given the SEC’s views addressed in the previous year.

Recent revisions to the exposure draft have been welcomed by the private company community, but there is more work to do before a final standard can be issued. The suggested model requires that all operating leases be capitalized as a right of use asset and amortized over the applicable lease period.

- **Uncertain tax positions** – A private company exception already exists in the form of reduced disclosures. An initial review by the PCC yielded limited feedback regarding improvement. However, given the initial private company reaction to the standard the topic remains on the table for consideration.

- **Development stage enterprises** – Released in June 2014, this provision eliminates certain presentation and disclosure requirements including providing inception to date financial information.

- **Stock-based compensation** – This issue addresses stock valuation issues for private companies including disclosure requirements and their usefulness.

- **Pension plans** – This topic addresses the various disclosure requirements for pension plans and other post-retirement benefits.

- **Liability vs. equity classification** – This topic is specifically related to mezzanine-level funding and the current differences for private and public companies regarding presentation.

- **Going concern** – This joint project with FASB involves transferring the responsibility from the auditor to management.

**Conclusion**

As evidenced by the flurry of activity, FASB and the PCC have been very effective with their objectives in the recent past. Private companies must continue to bring considerations to the PCC and remain active in the standard-setting process. The various private company alternatives should reduce compliance costs (e.g., reduce the need for complex valuations, hedge accounting requirements, VIE considerations) and complexity in comparison to the original standards.

It’s important for companies to understand these alternatives to see if they’re appropriate for their financial reporting needs. If applicable, consider these alternatives with your executive management team (and accounting advisor) well in advance of your 2014 audit fieldwork as the outcome may result in substantial changes (and potential fees) to the scope of the audit.
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web resources

1. CFMA Revenue Recognition Hub
   www.cfma.org/revenuerecognition
2. About the PCC www.fasb.org/pcc/aboutus
3. What Is Currently on the PCC’s Agenda?
   www.fasb.org/pcc/projects
4. PCC News
   www.accountingfoundation.org/jsp/Foundation/Page/FAFSectionPage&cid=1176158985794
5. AICPA Insights Blog blog.aicpa.org/2014/03/is-your-nonpublic-bank-or-credit-union-considered-a-public-entity.html#sthash.35zkImdn.dpbs
6. CFMA Webinar and Conference
   www.prolibraries.com/cfma