



*Private Company Financial Reporting
Task Force Report
Issued February 28, 2005*

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*Private Company Financial Reporting
Task Force Report
Foreword*

This document contains a concise overview related to the research efforts of the American Institute of Certified Public Accountants Private Company Financial Reporting Task Force. In addition to providing its analysis of the research results, the Task Force provides you with access to source information you might consider in developing your own opinions about the Task Force findings, conclusions, and recommendations.

To facilitate your exploring aspects of this topic and the work of the Task Force even further than this report can supply, the report contains web links that will take you to additional resources that relate to the topic in which the web link resides.

In addition, throughout several sections of the report, you will find parenthetical references to specific PowerPoint slides that contain survey data from the Task Force's two research efforts. For example, you may see a parenthetical reference that indicates "(see Slide 84, Random)." This reference is pointing you to the survey data that resides on the 84th slide in the Random Survey PowerPoint summary of responses prepared by a market research firm (a web link to that PowerPoint is provided to you in the Methodology section of this Report). If you choose to review Slide 84, you will see the data that supports the finding or information the parenthetical statement amplifies.

This document is designed for your ease of use in a web format. If you choose to print a hard copy of the report, you may do so by printing it from your web browser. Bear in mind, though, that the web version of the Report provides mechanisms for you to easily link to highlighted resources. If you print the report for your use and then later wish to go to one of the web links, you will have to do so manually by typing any URL references you want to navigate to. Or, you may go to the home page related to this effort at http://www.aicpa.org/members/div/acctstd/pvtco_fincl_reprt/index.htm

If you encounter any technical difficulties related to this report, please contact Sharon Macey at smacey@aicpa.org.



Private Company Financial Reporting Task Force Report

Executive Summary

In recent years, a growing number of interested parties, among them bankers and investors, business owners and managers, and CPA practitioners, have questioned the relevance of certain financial reporting requirements for privately held, for-profit entities (“private companies”). They have also raised concerns about the relative costs and benefits of complying with these requirements. The question is, do those expressing these concerns represent the majority of stakeholders to this reporting or are they simply a vocal minority? Another larger and more important question is, does private company financial reporting meet the needs of the key constituents of that reporting?

Today, 17,000 of the nation’s 4.9 million corporations are registered with the SEC, which translates to about 99.7 percent of the nation’s incorporated businesses being private companies.¹ Given the sheer number of private companies, their impact to the U.S. economy is significant. Recognizing this impact, the CPA profession’s role in private company financial reporting and the growing questions regarding the relevance and cost/benefit of certain aspects of this reporting, the Board of Directors of the American Institute of Certified Public Accountants (“AICPA”) formed the Private Company Financial Reporting Task Force (“Task Force”).

The Task Force, comprised of individuals representing private company financial reporting constituents, was charged with conducting research to explore whether:

- The general purpose financial statements of private companies, prepared in accordance with generally accepted accounting principles (“GAAP”), meet the financial reporting needs of constituents of that reporting; and whether
- The cost of providing GAAP financial statements is justified compared with the benefits they provide to private company constituents.

The Task Force was also charged with studying the results of its research to identify significant findings, if any, and if so, to draw from their backgrounds to

¹ Accounting Today. October 6-19, 2003. Page 3. Statistics of Income SOI Bulletin. Fall 2003. Volume 23, Number 2, Page 307.

reach conclusions and make recommendations based upon those findings and the experiences of its members.

For the purposes of its research, the Task Force defined the key constituents of private company financial reporting as being external stakeholders (primarily lenders, equity investors, and sureties), private company owners and financial managers, and public accounting practitioners.

In conducting its research, the Task Force undertook a disciplined process (please see the Methodology Overview at http://www.aicpa.org/members/div/acctstd/pvtco_fincl_reprt/download/Report_Draft_methodology.pdf) that included conducting focus groups and engaging an experienced and independent market research organization, The MSR Group of Omaha, Nebraska. The MSR Group facilitated both a stratified random sample (“Random Survey”) and an open, online survey (“Broad Outreach”). Following its receipt of the survey results from The MSR Group, the Task Force studied the results and developed a number of detailed findings, conclusions, and recommendations that are outlined in this Executive Summary and presented in detail in later sections of this report.

With an all-inclusive approach to this much-studied subject (see the “Background” section of this report), the Task Force did not approach its research with a preconceived notion that issues or problems with GAAP financial reporting for private companies existed. Instead, the Task Force sought feedback on whether or not GAAP financial reporting is meeting the financial reporting needs of private company constituents.

Taking this approach, the Task Force learned that general purpose financial statements of private companies prepared in accordance with GAAP have moderately high to high value to the constituents of that reporting, especially with respect to the characteristics of consistency and comparability.

The Task Force also learned, though, that respondents believe that many GAAP-specific requirements lack relevance or decision usefulness to private company constituents. In fact, when asked to rate the relevance or decision usefulness of a broad range of GAAP requirements on a scale of high, medium and low, all constituent group respondents who participated in the Random Survey rated certain GAAP requirements as being of low relevance or usefulness.

In addition, the Task Force found that a majority of each of the constituencies that had an opinion believe it would be useful if the underlying accounting in GAAP reporting were different, in certain instances, for public versus non-public (private) companies.

The Task Force also explored whether constituents view the cost/benefit relationship of private company financial reporting as being reasonable. Recognizing that it would be difficult if not impossible to quantify an answer to this question, the Task Force focused its effort on obtaining the overall views of the key constituents on the cost/benefit relationship.

Respondents rated the benefits of preparing or using GAAP financial statements when compared with the cost of preparing them as medium to moderately high. This finding appears to conflict with respondents' low relevance ratings of many GAAP-specific requirements and the support (in certain instances) for differences in the underlying accounting of GAAP. The Task Force observes that the ratings on benefits in relation to costs may reflect the favorable ratings given on the overall value of GAAP.

Combining the survey findings and the experiences and perspective of each Task Force member drawn from his/her background as business owners and managers, practitioners, lenders, investors, and a former standards setter, the Task Force unanimously concluded that:

- **GAAP for private companies should be developed based on concepts and accounting that are appropriate for the distinctly different needs of constituents of that financial reporting;**
- **Although GAAP with exceptions and other bases of accounting are being used and are sometimes appropriate, the Task Force does not believe that these exceptions and other bases of accounting are the best response to the private company financial reporting findings identified in this study.** On the contrary, the Task Force is concerned that increasing the prevalence of such GAAP exceptions will erode the recognized overall value of GAAP reporting, and the use of other bases of accounting may not adequately meet the needs of private company constituents; and
- **Fundamental changes should be made in the current GAAP standards-setting process to ensure that the financial reporting needs of private company constituents are met.**

The mission of the Task Force did not include defining the structure for implementing fundamental changes to the standards-setting process for private company financial reporting (because at the outset of its work, it was not known if this was applicable). Instead, to address its findings and conclusions, the Task Force recommends **that a cooperative effort that includes representatives of the key constituents of private company financial reporting, be undertaken to:**

- **Determine who should establish private company GAAP;**
- **Identify how to best effect fundamental change in the GAAP standards-setting process to ensure that the financial reporting needs of private company constituents are met; and**
- **Develop and oversee the implementation process on a timely basis.**

To facilitate this, the Task Force recommends that outreach be extended to the Financial Accounting Standards Board (“FASB”) and its Financial Accounting Foundation (“FAF”) to work cooperatively to effect the fundamental changes noted above or that a commission, representative of the key constituents of private company financial reporting, be formed.

The Task Force believes that developments in this area indicate that substantive change is now required and that steps must be taken to better meet the GAAP financial reporting needs of private company constituents. Therefore, the Task Force urges timely change.

Background

General purpose financial reporting is designed to meet the needs of external stakeholders who lack the ability to prescribe and obtain the information they need and, therefore, must rely on the financial information that companies provide. In addition, financial reporting is directed toward the common interests of various potential users of that reporting for making investment and credit decisions. The standards for external financial reporting are known as GAAP.

In many cases, external users of private company financial reporting have the ability to obtain the financial information they require directly from those private companies. Still, for various reasons, many private companies prepare financial statements in accordance with GAAP.

In recent years, growing questions about the relevance of certain financial reporting requirements for private companies and the cost/benefit equation of complying with them have caused some to ask whether or not general purpose financial statements of private companies, when prepared in accordance with GAAP, are meeting the financial reporting needs of the constituents of that reporting. However, it was unclear whether those raising the questions represented the majority or a vocal minority of interested parties.

Over the past three decades, a number of organizations have studied this subject, including the AICPA and the Financial Accounting Standards Board (“FASB”) in the United States. Nevertheless, these organizations have not conducted an in-depth study of this issue in recent years. Recently, a number of standards setters have studied the topic internationally and have implemented, or are considering implementing, varying degrees of changes to their standards or standards-setting structure. For more information on past research on this topic in the United States, please go to

http://www.aicpa.org/news/2004/2004_0308_privco_finreprtng.htm.

In early 2004, the AICPA Board appointed the Task Force to conduct comprehensive research to explore whether:

- The general purpose financial statements of private companies, prepared in accordance with GAAP, meet the financial reporting needs of constituents of that reporting; and whether
- The cost of providing GAAP financial statements is justified compared with the benefits they provide to private company constituents.

The Task Force was also charged with studying the results of its research to identify significant findings, if any, and if so, to draw from their backgrounds to

reach conclusions and make recommendations based upon those findings and the experiences of its members.

The AICPA Board stressed the importance of conducting unbiased research with all key constituents to determine whether those questioning the relevance of certain GAAP financial reporting requirements are representative of the views of key constituents of that reporting. For the purposes of this research, the key constituents of private company financial reporting were defined to include external stakeholders (primarily lenders, equity investors, and sureties), private company owners and financial managers, and public accounting practitioners.

GAAP Financial Reporting

The broad elements of GAAP financial reporting relate to the following:

- Recognition - for example, assets, liabilities, equity, revenue and gains, expenses and losses, and other comprehensive income;
- Measurement - for example, historical cost, fair value, or lower of cost or market, and the measurement methodology used;
- Presentation - for example, balance-sheet display; and
- Disclosure - for example, notes to financial statements.

In almost all cases, GAAP currently does not provide for different underlying accounting (that is, recognition and measurement principles) based on whether an entity is public or private. However, GAAP sometimes provides for differences in presentation, disclosure, transition methods and effective implementation dates. In exploring whether or not private company GAAP financial statements are meeting the needs of the constituents of that reporting, the Task Force recognized that its conclusion might depend on consideration of one, some, or all of the broad elements listed above.

In addition, the costs related both to providing and not providing certain information in general purpose financial statements require consideration. Consequently, the Task Force recognized that another important question is whether constituents view the cost/benefit relationship of private company financial reporting as being reasonable. Recognizing that it would be difficult if not impossible to quantify an answer to this question, the Task Force focused its efforts on obtaining the overall views of the key constituents on the cost/benefit relationship.

Methodology

The Task Force and AICPA staff met a total of 8 times in person and 10 times by teleconference from the time period beginning January 12, 2004 through February 11, 2005.

During its initial meetings, the Task Force took the following steps:

- Agreed on objectives for its measurement processes that would solicit the input of the key constituents of private company financial reporting versus soliciting only the input of financial reporting “thought leaders.” The process included:
 - Using statistically sound research procedures;
 - Ensuring a lack of bias; and
 - Conducting a grassroots, broad outreach effort.
- Considered the broad range of private company financial reporting constituencies and narrowed the list to those they defined as the key constituencies for the purposes of this research. These key constituents were defined as:
 - External stakeholders who serve private companies (primarily lenders/creditors, equity investors and sureties);
 - Owners and financial managers of private companies. Private companies were defined to include for-profit, non-SEC registrants; and
 - Public accounting practitioners who serve private companies.
- Created a discussion paper designed to help ensure an informed dialogue on the topic. To review a copy of this discussion paper, please go to http://www.aicpa.org/download/news/2004/Discussion_Paper_5-10-04.pdf;
- Engaged the assistance of an experienced, market research organization, The MSR Group of Omaha, Nebraska;
- Designed a construct for conducting a survey using a stratified random sample and CATI/Web Mixed Mode methodology (“Random Survey”). This survey called for The MSR Group to randomly call participants, screen them for eligibility, and then offer them the ability to complete a survey by telephone or online;
- Designed a separate online-only Broad Outreach Survey (“Broad Outreach”) to ensure that interested parties were offered the opportunity to voice their opinions on this subject. The Broad Outreach Survey was designed to mirror the Random Survey such that the results of the two surveys could be directly compared to one another;
- Developed drafts of four survey instruments designed to measure the degree to which GAAP financial reporting was meeting the needs of the key

constituent groups (as noted above) as well as other interested constituents, for example, educators. To review these survey questionnaires, please go to http://www.aicpa.org/members/div/acctstd/pvtco_fincl_reprt/survey_quesets.htm;

- Engaged the participation of various organizations to help generate awareness of the Broad Outreach Survey and encourage their members/constituents to voice their opinions. Please go to http://www.aicpa.org/download/acctstd/2004_0927_stmt.pdf for a list of the participating organizations;
- Assisted The MSR Group in obtaining lists from various sources for the random sampling.

The Task Force agreed at the outset of this process that the data collected in the Random Survey would be used as the primary basis for its findings, given that the online, open methodology used for the Broad Outreach Survey allowed all Broad Outreach respondents to self-select themselves. Therefore, the Broad Outreach data was used by the Task Force to provide a platform for those with an interest in sharing their views and to gain a further perspective on the results of the Random Survey.

In addition, the Task Force recognized that respondents are only willing to spend a limited amount of time completing surveys. For this reason, the Task Force sought to gain a general sense from respondents about whether private company financial statements prepared in accordance with GAAP are effectively meeting the needs of various constituencies and whether or not the benefits justify the cost of preparing financial statements in accordance with GAAP. For example, the survey asked respondents about the relevance/decision usefulness of 12 GAAP-specific requirements (as discussed in the Task Force Findings section of this report). However, the survey did not ask respondents to explain their rationale for the ratings they gave for particular GAAP-specific requirements (or standards). Also, the Task Force did not ask respondents to suggest any proposed solutions within the context of a specific GAAP standard.

A complete overview of the Task Force methodology may be found at http://www.aicpa.org/members/div/acctstd/pvtco_fincl_reprt/download/Report_Draft_methodology.pdf. You will find The MSR Group's Random report at http://www.aicpa.org/members/div/acctstd/pvtco_fincl_reprt/download/Random_Research_Survey_Results.ppt and the Broad Outreach Survey report is available for your review at http://www.aicpa.org/members/div/acctstd/pvtco_fincl_reprt/download/Broad_Outreach_Research_Survey_Results.ppt.

Survey Participation

1,008 people completed the Task Force's Random Survey, and 2,701 completed the Broad Outreach Survey, for a total of 3,709 responses. The specific participation is described in the following sections:

Random Survey

- 301 external stakeholders completed the survey; with a specific breakdown of 100 lenders, 101 investors and 100 sureties;
- 300 business owners and financial managers completed the survey, with an identical number in the three revenue categories of less than \$5 million, \$5 to \$25 million, and over \$25 million; and
- 407 public accounting practitioners completed the survey, in the following firm category sizes:
 - 107 from firms with 5 or less partners;
 - 100 from firms with 6 to 10 partners;
 - 100 from firms with 11 to 20 partners; and
 - 100 from firms with 21 or more partners.

Broad Outreach

In addition to those who completed the Random Survey, the following groups chose to complete the online, self-selected Broad Outreach survey:

- 352 external stakeholders who serve private companies, including:
 - 213 from creditors/lenders;
 - 41 from investor/venture capital firms;
 - 91 from surety/bonding/insurance firms; and
 - 7 from other types of firms.
- 912 owners/managers of private companies, including:
 - 173 with revenue under \$5 million;
 - 288 with revenue of \$5 million to \$25 million;
 - 428 with revenue over \$25 million; and
 - 23 who did not provide company revenue information.
- 1,295 practitioners (accountants engaged in the practice of public accounting and serving private companies), including:
 - 706 from firms with 5 or fewer partners;
 - 232 from firms with 6 to 10 partners;
 - 119 from firms with 11 to 20 partners;
 - 233 from firms with 21 or more partners; and
 - 5 who did not provide the number of partners in their firm.
- 142 General Survey respondents did not classify themselves in any of the constituency groups above.

Constituent Roles

The Task Force believes it is important to understand the nuances of the roles played by the constituents in the private company financial reporting environment.

The owner/manager may be strictly an owner or manager in the business, or he/she may also be the person who prepares financial statements for his/her company. Of the 254 business owners surveyed in the Random Survey, 138 or 54 percent of them, identified themselves as both owners and preparers (see Slide 21, Random).

Practitioners often perform multiple roles in serving their clients. They may be instrumental in helping to prepare or provide assurance on financial statements. In fact, of the owners/managers who indicated that they do not prepare their company's financial statements, from 41 percent of the respondent businesses over \$25 million to 74 percent of the respondent businesses under \$5 million indicated that they use an outside accountant to prepare their financial statements (see Slide 23, Random). In addition, the outside practitioner may also act as a liaison to external capital providers for his/her private company clients or as an adviser to both private companies and external stakeholders.

The external stakeholder is often the primary user of general purpose, private company financial statements. Of those owners/managers who indicated that they prepare financial statements for external use, lenders and creditors were the external stakeholders mentioned most often as the users for whom the owner/manager prepared GAAP financial statements (see Slide 26 and Slide 27, Random).

Of the external stakeholders surveyed, a majority indicated that the reasons they want GAAP financial statements are:

- For use as a decision making tool;
- Because they provide useful information;
- Because they provide a standardized language;
- Because they allow for comparability between reporting periods and with other companies; and
- Because they want an outside accountant's report (see Slide 43, Random).

A majority of these same external stakeholders indicated that they want GAAP financial statements for protection, while the majority of lenders want GAAP financial statements for regulatory reasons, among other reasons (see Slide 43, Random).

Task Force Findings

The following findings are based on the results of the Random Survey. The Broad Outreach Survey is mentioned only if the results varied significantly from the Random Survey.

GAAP Financial Reporting – Overall Value

When the Task Force sought to determine the value of GAAP in providing comparability between periods and among companies, all three constituent groups (private company owners and financial managers, practitioners and external stakeholders) rated the value of GAAP in providing comparability between periods and among companies on a scale of low (1), medium (2), or high (3) as being moderately high to high (see Slide 78, Random, ratings from 2.3-2.8).

Additionally, all constituent groups rated the value of having an independent accountant's report as being moderately high to high (see Slide 80, Random, ratings from 2.5-2.9). External stakeholders rated the value of GAAP financial statements when accompanied by an independent accountant's report higher than virtually all other GAAP attributes surveyed, rating it 2.7 or 2.8 out of 3.0 (see Slide 80, Random).

The Task Force also asked a series of questions to determine the value of GAAP financial statements in terms of their usefulness in a private company's ability to:

- Raise capital from lenders, investors, or others;
- Obtain credit from vendors or suppliers;
- Qualify for bidding on contracts or obtain licenses; and
- Manage, plan, or forecast for business.

Overall, owners/managers and external stakeholders rated the value of GAAP financial statements in each of the areas above as medium to high (see Slides 71-74, Random; ratings range from 1.9 to 2.8).

In addition, external stakeholders rated the value of GAAP financial statements for private companies as a tool in making investment or credit decisions, a check and balance against other tools they may use in making investment or credit decisions and to execute their investment strategy as being of medium to moderately high value (see Slides 75-77, Random; ratings range from 2.2 to 2.6).

Relevance and Usefulness of GAAP Requirements

Although the survey results indicate that the overall value of GAAP financial statements is moderately high to high, many GAAP-specific requirements were rated as having low relevance or decision usefulness.

One of the questions asked respondents to rate the relevance or decision usefulness, and rate the level of effort or challenge to comply with or understand 12 GAAP requirements. These 12 GAAP requirements were selected based on inputs from experienced Task Force members and feedback received during focus groups. The question included both long-standing and relatively newer GAAP requirements, and respondents were asked to rate the relevance or decision usefulness of the GAAP requirements on a scale of low (1), medium (2), and high (3). They could also indicate that a particular GAAP requirement did not apply to them or they did not know.

All constituent groups rated certain GAAP requirements as being of low relevance or usefulness (see Slide 68, Random). The chart on the following page illustrates these 12 GAAP requirements and how they were rated by each constituent group.

Relevance/Decision Usefulness of Specific GAAP Requirements by Mean Scores.

(n=approximately 60-90, depending on requirement and cell)

[Average scores on a scale of 1 (Low) to 3 (High), excluding Don't Know and Not Applicable responses. The table is sorted in descending order for owner/manager firms with less than \$5 Million in revenue. Scores of 2.0 (Medium) are highlighted in orange, while those of 1.9 or lower (Low) are highlighted in blue.]

	Owners/Managers by Revenue (Millions)			Practitioners by Number of Partners				External Stakeholders by Type of Firm		
	<\$5M	\$5-\$25M	>\$25M	5 or less	6-10	11-20	21 or more	Creditor/Lender	Investor/Venture Capital	Surety/Bonding
Accrual basis of accounting	2.5	2.6	2.7	2.7	2.9	2.8	2.8	2.7	2.6	2.6
Cash flow statement	2.5	2.5	2.6	2.3	2.5	2.6	2.5	2.8	2.9	2.5
Comprehensive income measurement	2.3	1.8	1.9	1.6	1.7	1.7	1.5	2.2	2.1	2.2
Classification of liabilities and equity	2.2	2.1	2.3	2.1	2.2	2.1	2.2	2.4	2.4	2.5
Fair value basis of measuring assets and liabilities	2.2	1.9	2.1	1.7	1.8	1.9	2.0	2.4	2.2	2.4
Post retirement and retirement plans	2.0	2.0	1.9	1.8	2.2	2.1	2.4	1.7	1.4	1.7
Deferred income taxes	2.0	1.8	2.0	1.7	2.2	2.0	2.2	2.1	1.7	2.3
Leases	1.9	1.9	2.0	2.2	2.4	2.3	2.3	2.0	2.0	2.0
Guarantees	1.9	1.6	1.7	1.7	2.1	2.0	2.1	2.4	1.9	2.3
Intangibles	1.8	1.6	1.5	1.7	2.0	1.8	2.1	1.9	1.8	2.0
Variable interest entities	1.8	1.5	1.9	1.7	1.9	1.9	2.1	1.7	1.5	1.9
Share-based payments	1.6	1.4	1.5	1.2	1.6	1.5	2.0	1.5	1.9	1.7

Note: As a very general statement, differences between means are usually statistically significant if they differ by .2 or more. Testing would have to be done between any specific pairs of interest to verify a significant difference, since both the average score and response distribution are factored into significance testing.

In the Broad Outreach Survey, owners/managers and practitioners more strongly communicated their low relevance rating while external stakeholders rated the decision usefulness of GAAP requirements more favorably. Still, the Task Force observes that the decision usefulness of certain GAAP requirements was rated as low by external stakeholders in both the Random and Broad Outreach Surveys.

Different Underlying Accounting in GAAP

Public/Private

A majority of each of the constituencies who had an opinion believe it would be useful if the underlying accounting in GAAP reporting were different, in certain instances, for public versus non-public (private) companies (see Slide 84, Random). The single exception is surety respondents in the Broad Outreach Survey.

A higher percentage of owners/managers who prepare their company's financial statements believe it would be useful if the underlying accounting in GAAP reporting were different, in certain instances, than those who do not prepare their company's financial statements (see Slide 84, Random).

An overwhelming majority of practitioners who had an opinion believe it would be useful if the underlying accounting in GAAP reporting were different, in certain instances, for public versus non-public (private) companies. Specifically, this majority ranged from 78 percent to 90 percent, depending on the size of their firm (see Slide 84, Random). From 1 percent to 6 percent of practitioners did not know or have an opinion.

Additionally, 21 percent to 36 percent of owners/managers and 9 percent to 20 percent of external stakeholders did not know or have an opinion when asked this question in the Random Survey (see Slide 84, Random). This differed for the owners/managers and external stakeholders in the Broad Outreach survey, with a lower level of uncertainty from owner/managers (from 9 percent to 18 percent) and a higher level of uncertainty from external stakeholders (from 22 percent to 31 percent) (see Slide 84, Broad Outreach).

The Task Force observes that the relatively high percentage of "don't know" or "no opinion" answers received from owner/manager responses in the less than \$5 million revenue group within the Random Survey may reflect that constituency's heavy reliance on their practitioner for guidance in this area.

Overall, even with this relatively high level of uncertainty, the prevalent opinion in both the Random and Broad Outreach surveys is that it would be useful to

have different underlying accounting, in certain instances, for public versus private companies (see Slide 84, Both).

The Task Force's review of historical research in the U.S. indicates that the support for differences in underlying accounting, in certain instances, for public versus private companies in this research significantly exceeds that of previous studies, particularly among owners/managers and external stakeholders (see http://www.aicpa.org/news/2004/2004_0308_privco_finreprtng.htm).

Size

The data also indicates support for different standards, in certain instances, based on the size of the company reporting. From 59 percent to 62 percent of owner/manager respondents, 65 percent to 77 percent of practitioners, and 44 percent to 69 percent of external stakeholders believe it would be useful if the underlying accounting in GAAP reporting were different, in certain instances, based on the size of companies (see Slide 85, Random).

A lower degree of uncertainty existed with this differences-in-size question, with only 0 percent to 4 percent of practitioners, 12 percent to 18 percent of owners/managers, and 2 percent to 8 percent of external stakeholders answering that they did not know or have an opinion (see Slide 85, Random).

GAAP Challenges

When asked how challenging it is to keep current and up-to-date on GAAP standards, all constituent groups believe that it is somewhat to extremely challenging to keep current (see Slide 83, Random). In fact, the following responses represent those who believe it is extremely challenging to keep up (see Slide 83, Random):

- 17 percent to 27 percent of owner/manager respondents;
- 24 percent to 26 percent of external stakeholders; and
- 41 percent to 74 percent of all practitioners.

External stakeholders rated many of the 12 GAAP requirements as being of low challenge to understand/use, but did indicate that some of those GAAP requirements were of medium challenge to understand and use (see Slide 69, Random).

When asked to rate the challenge to comply with the same 12 GAAP requirements, owners/managers rated certain of those requirements as being of medium challenge and practitioners rated certain of those requirements as being of high challenge to comply (see Slide 69, Random).

The findings related to the practitioners' challenge to comply may be noteworthy because practitioners help to prepare financial statements for a significant number of private companies. In fact, of the owners/managers who indicated that they do not prepare their company's financial statements, from 41 percent of the respondent businesses over \$25 million to 74 percent of the respondent businesses under \$5 million, also indicated that they use an outside accountant to prepare their financial statements (see Slide 23, Random). And, based on the value placed on GAAP financial statements when accompanied by an outside accountant's report noted previously, the practitioner's ability to keep current and up-to-date may be an issue for them and, consequently, for the users of the financial statements they prepare (owners/managers and external stakeholders).

GAAP Benefits Compared with Costs

All respondent groups rated the benefit of preparing or using GAAP financial statements compared with the cost of preparing them as medium to moderately high (see Slide 81, Random, ratings from 2.2 to 2.4). In the Broad Outreach Survey, small firm practitioners rated the benefit of preparing or using GAAP financial statements compared with the cost of preparing them lower than others did (see Slide 81, Broad Outreach).

GAAP Exceptions and Other Bases of Accounting

Of the 448 private companies contacted as a result of the Random Survey, 132 of those surveyed or 29 percent, reported that they do not prepare, issue or release financial statements for external purposes (see Slide 12, Random). These respondents indicated that they do not do so because they had little or no borrowing, no external requests and/or the owner guarantee was sufficient in obtaining capital.

Private company respondents who indicated that they do prepare GAAP financial statements for external purposes, disclosed that they prepare those statements primarily for lenders/creditors, management and/or shareholders (see Slide 26, Random).

The Task Force also learned that only 10 percent to 14 percent of the owner/manager respondents reported ever issuing financial statements prepared in accordance with GAAP, but with exceptions to certain GAAP requirements (see Slide 28, Random). In addition, only 4 percent to 9 percent of that same constituency reported ever asking if they could issue financial statements either on a basis other than GAAP or with GAAP exceptions (see Slide 31, Random).

Although they indicated that they want GAAP financial statements, a significant majority of external stakeholders have accepted financial statements *on a basis of*

accounting different from GAAP (for example, cash basis or tax basis; 58 percent to 93 percent; see Slide 44, Random) or *with exceptions to GAAP* (61 percent to 71 percent; see Slide 49, Random).

The percent of external stakeholders that ever accept financial statements of privately-held, for-profit companies on a basis of accounting different from GAAP varied by the type of external stakeholder as follows (see Slide 44, Random):

- 93 percent of creditors/lenders accepting other bases;
- 58 percent of investor/venture capital firms accepting other bases; and
- 72 percent of surety/bonding firms accepting other bases.

Of those that do accept non-GAAP financials statements, 64 percent to 79 percent report that the size of the company is a factor in their decision as to whether or not to accept them (see Slide 46, Random).

The percent of external stakeholders that ever accept financial statements prepared in accordance with GAAP but with exceptions to certain GAAP requirements also varied by the type of external stakeholder as follows (see Slide 49, Random):

- 71 percent for creditors/lenders accepting exceptions;
- 61 percent for investor/venture capital firms accepting exceptions; and
- 65 percent for surety/bonding firms accepting exceptions.

From 48 percent to 69 percent of practitioners surveyed reported that their private company clients have ever issued financial statements in accordance with GAAP but with exceptions to certain GAAP requirements, or have ever asked external parties (such as lenders and investors) whether the company could issue financial statements either on another basis of accounting different from GAAP or with exceptions to certain GAAP requirements (see Slide 36 and 39, Random).

Task Force Conclusions and Recommendations

Combining the survey findings and the experiences and perspective of each Task Force member drawn from his/her background as business owners and managers, practitioners, lenders, investors, and a former standards setter, the Task Force developed unanimous conclusions and recommendations as described in the following sections:

GAAP for Private Companies

The Task Force concludes that GAAP currently is not adequately meeting the distinctly different needs of private company constituents. Therefore, GAAP for private companies should be developed based on concepts and accounting that are appropriate for the distinctly different needs of constituents of that financial reporting.

This conclusion is based upon the findings outlined in the previous section, including the fact that:

- Many of the 12 GAAP-specific requirements related to private company financial statements were determined to be low either in relevance or decision usefulness when private company constituents were asked to rate them; and
- A majority of each of the constituencies who had an opinion believe it would be useful if the underlying accounting in GAAP reporting were different, in certain instances, for public versus non-public (private) companies.

Distinctly Different Needs

The Task Force concludes that the lower relevance ratings of many of the 12 GAAP-specific requirements mean that they are not adequately meeting the needs of the private company constituents. Based upon its collective experiences, the Task Force members believe that these lower relevance ratings reflect the distinctly different needs of constituents of private company financial reporting.

The Task Force also believes that the distinction between private and public companies is a more significant determinant factor of the difference in needs than the size of the companies themselves. Some examples of factors that the Task Force believes drive a difference in needs between private and public companies include:

- Capital succession considerations, or planned transfer of ownership;

- Different capital structures such as the prevalence of S-corporations, proprietorships, partnerships and limited liability companies;
- Income and estate tax planning considerations;
- Multiple entities with common private ownership;
- Common use by lenders of loans with personal guarantees and cross collateralization;
- GAAP financial statements primarily prepared for external lenders who may have direct access to company information (see Slide 26, Random);
- Ownership typically being closely held and owners often being active rather than passive investors; and
- The concept of private companies having stewardship needs versus valuation considerations of a public entity.

The Task Force acknowledges that, when applying its conclusions and recommendations, the definition of private companies may need to be refined. For example, whether or not to include regulated industries in the definition of private companies should be considered.

A GAAP Solution

The Task Force concludes that external stakeholders of private company financial reporting often have access to the financial information they deem necessary to make their investment and credit decisions. Even with this access, external stakeholders want GAAP financial statements. This Task Force conclusion is based on findings from its external stakeholder focus groups, findings from the Random survey, and the Task Force members' individual experiences.

And, despite the concerns about the low relevance of GAAP-specific requirements and the support (in certain instances) for differences in the underlying accounting of GAAP, respondents rated the overall value of GAAP moderately high to high. They also rated the benefits of preparing or using GAAP financial statements when related to the cost of preparing them as medium to moderately high. The Task Force supposes that the ratings on benefits in relation to costs reflect the ratings given on the overall value of GAAP.

Further, although GAAP with exceptions and other bases of accounting are being used and are sometimes appropriate, the Task Force does not believe that these exceptions and other bases of accounting are the best response to the private company financial reporting findings identified in this study. On the contrary, the Task Force is concerned that increasing the prevalence of such GAAP exceptions will erode the recognized overall value of GAAP reporting, and the use of other bases of accounting may not adequately meet the needs of private company constituents.

As a result, the Task Force believes that any private company financial reporting solution must be a widely-embraced, recognized set of standards that are generally accepted accounting principles.

Fundamental Change Needed

The Task Force also concludes that fundamental changes should be made in the current GAAP standards-setting process to ensure that the financial reporting needs of private company constituents are met. The Task Force recommends that the revised GAAP standards-setting process for private companies possess at least the following attributes:

- Incorporate concepts appropriate to meet the financial reporting needs of private company constituents;
- Tailor due process to private company constituents;
- Have appropriate funding;
- Have dedicated staff to focus on private company issues; and
- Be recognized as GAAP for private companies.

The mission of the Task Force did not include defining the structure for implementing the fundamental changes to the standards-setting process for private company financial reporting (because at the outset of its work, it was not known if this was applicable). However, the range of alternatives, incorporating the above-mentioned attributes, could include:

- Changing the composition of the FASB and the FAF to be more representative of private company constituents; or
- Increasing private company constituents' representation on the FAF and establishing a new private company GAAP standards-setting board under FAF that would only address the needs of these constituents; or
- Creating a new private company GAAP standards-setting board outside of the FAF.

Recommended Action

The Task Force, therefore, recommends that a cooperative effort that includes representatives of the key constituents of private company financial reporting be undertaken to:

- Determine who should establish private company GAAP;
- Identify how to best effect fundamental change in the GAAP standards-setting process to ensure that the financial reporting needs of private company constituents are met; and
- Develop and oversee the implementation process on a timely basis.

To facilitate this, the Task Force recommends that outreach be extended to the FASB and its FAF to work cooperatively to effect the fundamental changes noted above or that a commission, representative of the key constituents of private company financial reporting, be formed.

The Task Force believes that developments in this area indicate that substantive change is now required and that steps must be taken to better meet the GAAP financial reporting needs of private company constituents. Therefore, the Task Force urges timely change.

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