United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510–6250

January 11, 2012

VIA EMAIL (PrivateCompanyPlan@f-a-f.org)

Financial Accounting Foundation
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

RE: Plan to Establish the Private Company Standards Improvement Council

Dear Board of Trustees of the Financial Accounting Foundation:

The purpose of this letter is to express opposition to the proposal to create a Private Company Standards Improvement Council (PCSIC) authorized to vote on proposals to alter U.S. Generally Accepted Accounting Principles (GAAP) by providing exceptions and special rules for private companies, subject to approval by the Financial Accounting Standards Board (FASB). This new voting council represents an unprecedented approach to U.S. accounting standards that would weaken GAAP, reduce transparency, and conflict with international accounting standards, while producing few benefits for financial statement users.

Accounting Principles. The U.S. Senate Permanent Subcommittee on Investigations has a longstanding interest in U.S. accounting principles that support transparent and useful financial reports needed to facilitate investment, combat fraud, and foster a strong U.S. economy. Its investigations have included exposing the accounting deceptions used by Enron Corporation, the seventh largest U.S. corporation prior to its collapse,[1] the development and sale of financial products by Citicorp and JPMorgan Chase to help corporations hide debt on their financial statements,[2] and the development and sale of abusive tax shelter and other schemes by accounting firms and other professionals to minimize corporate taxes and inflate corporate earnings.[3]

Misleading accounting practices are not limited to publicly traded corporations. Recent history is replete with examples of private companies that have engaged in accounting abuses to the detriment of investors, their communities, and the U.S. economy as a whole. One egregious example involves the ponzi scheme carried out by Bernard L. Madoff Investment Securities LLC, which was largely facilitated by deceptive accounting practices[4] and may have cost

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[1] See "The Role of the Board in Enron's Collapse," S.Hrg. 107-511 (May 7, 2002).
[2] See "The Role of Financial Institutions in Enron's Collapse," S.Hrg. 107-618 (July 23 and 30, 2002).
[3] See, e.g., "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals," S.Hrg. 108-473 (November 18 and 20, 2003); "Tax Haven Abuses: The Enablers, The Tools and Secrecy," S.Hrg. 109-797 (August 1, 2006), case histories involving the POINT strategy and Kurt Greaves.
[4] See, e.g., SEC v. Friehling, Case No. Civ. 09 CV 2467 (SDNY, filed March 18, 2009); "David Friehling, Madoff's Accountant, Sentencing Postponed … Again," Forbes, Walter Pavlo (September 16, 2011),

investors $50 billion.[5] An infamous earlier example of the deceptive accounting practices available to private companies involves Phar-Mor, a retail chain whose executives were found to have hidden millions in losses from investors, ultimately bankrupting a once-promising enterprise.[6] The U.S. Securities and Exchange Commission (SEC) has taken enforcement action against a raft of smaller private firms involved with so-called "microcap fraud," in which companies with little or no real business use unaudited financial statements and other financial records to obtain funds from investors.[7] The U.S. Commodities Futures Trading Commission (CFTC) regularly takes enforcement action against private commodity pool operators that have defrauded clients, often by providing misleading financial statements. For example, last month, a North Carolina investment group known as Queen Shoals paid $24 million to settle a CFTC complaint charging it with operating a fraudulent foreign currency trading scheme.[8]

These and other cases of accounting deception establish the importance of vigorous accounting standards for private as well as public corporations to protect investors and the public from misleading financial reports, financial loss, and economic injury.

Undermining GAAP. The stated purpose of the new PCSIC is to provide exceptions and modifications to GAAP for all "nonpublic business entities, regardless of size."[9] While the proposal states that its intent is not to encourage the creation of two different versions of GAAP,[10] that is the inevitable consequence of the proposal.

In the United States, over 22 million corporations are privately held, compared with 17,000 that are publicly traded.[11] Many private corporations are of substantial size and have become household names, such as Toys R Us, Facebook, Cargill, Mars Candy Company, and

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http://www.forbes.com/sites/walterpavlo/2011/09/16/david-friehling-madoffs-accountant-sentencing-postponed-again/.

[5] See SEC v. Madoff, Case No. 08-CV-10791, (SDNY, filed December 11, 2008).

[6] See SEC v. Monus, Case No. 4:95 CV 975, (NDOH, filed May 2, 1995). See also PBS Frontline Documentary, "How to Steal $500 Million," (November 8, 1994), transcript available at http://www.pbs.org/wgbh/pages/frontline/programs/transcripts/1304.html.

[7] See, e.g., "SEC Charges 41 People in 13 Actions Involving More than $25 Million in Microcap Fraud," SEC press release (Sept. 24, 1998), http://www.sec.gov/news/press/pressarchive/1998/98-92.txt.

[8] See CFTC v. Queen Shoals LLC, Case No. 3:11-CV-00132, (WDNC, filed August 4, 2009), http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfqueenshoalscomplaint0804200.pdf; "Federal Court Orders Charlotte, NC, Couple and Their Companies to Pay $24 Million for Defrauding Customers in Foreign Currency Ponzi Scheme," CFTC press release (November 1, 2011), http://www.cftc.gov/PressRoom/PressReleases/pr6133-11; "Queen Shoals Execs, CFTC Settle $22M Fraud Case," Law360, by Megan Stride (July 12, 2011), http://www.law360.com/banking/articles/257383/queen-shoals-execs-cftc-settle-22m-fraud-case.

[9] "Request for Comment, Plan to Establish the Private Company Standards Improvement Council," Financial Accounting Foundation Board of Trustees, (October 4, 2011), http://www.accountingfoundation.org/cs/ContentServer?site=Foundation&c=Document_C&pagename=Foundation%2FDocument_C%2FFAFDocumentPage&cid=1176158991959.

[10] "Financial Accounting Foundation Board of Trustees Plan to Establish the Private Company Standards Improvement Council," http://www.accountingfoundation.org/cs/ContentServer?site=Foundation&c=Document_C&pagename=Foundation%2FDocument_C%2FFAFDocumentPage&cid=1176158992373.

[11] "Roadmap Ahead for Private Company Accounting Standards GAAP Models for Private Companies," Private Company Financial Reporting Committee, (April 2008) at 1, http://www.accountingfoundation.org/cs/ContentServer?c=Document_C&pagename=Foundation%2FDocument_C%2FFAFDocumentPage&cid=1176157151116.

Koch Industries.[12] In addition, many large private equity firms are privately held. Bain Capital LLC, for example, has over $60 billion in assets under management.[13] Enabling those private companies to obtain their own accounting exceptions or special rules would affect the accounting practices of the vast majority of U.S. corporations in existence today, while effectively limiting the applicability of GAAP to the comparatively small universe of public traded corporations.

In addition to limiting GAAP's applicability to a small subset of U.S. corporations, the proposal would establish a council whose only mission is to create exceptions and special rules in competition with GAAP, based upon a corporation's status rather than its size. Common sense dictates that the resulting accounting rules would be more lenient toward the private companies objecting to the existing GAAP requirements. Once approved, the resulting exceptions and special rules would apply to the vast majority of U.S. corporations, inherently undermining the justification for the tougher GAAP standards applicable to publicly traded corporations. In time, the exceptions could swallow the rules which, by then, would apply to a minority of U.S. corporations.

Creating a separate council to issue special rules for private companies would also signal support for accelerating the establishment of more GAAP exceptions, a development that is not justified by recent corporate history in the United States. Establishing a council that will accelerate GAAP exceptions will inevitably weaken and fragment GAAP, not strengthen it.

Reducing Transparency. In addition to undermining GAAP, the PCSIC proposal would reduce the transparency of corporate financial statements of U.S. private corporations. Private corporations are already less transparent than their publicly traded counterparts.[14] Encouraging GAAP exceptions and special rules for those private corporations would allow them to become even less transparent while inviting complications and confusion about their financial reporting and possibly discouraging investment. In addition, more lenient accounting rules may encourage public companies to go private, in order to avoid transparency and required financial disclosures.

Private companies are generally not required to file financial reports with the U.S. Securities and Exchange Commission (SEC), and may not have to file financial statements with any State. If, however, they provide a GAAP-compliant financial statement to an investor, lender, regulator, or other person, the user of that financial statement should be able to review financial information that is largely consistent with the data available on public companies.

Consistency between the financial statements of private and public companies is valuable to investors, lenders, regulators, and others.[15] Consistency makes it possible for users of financial statements to evaluate a corporation and determine its financial condition in a familiar and comprehensible format. Uniformity between private and public company financial

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[12] "America's Largest Private Companies 2011," Forbes (November 2011), http://www.forbes.com/lists/2011/21/private-companies-11_land.html.
[13] See, e.g., Bain Capital LLC, http://www.baincapital.com.
[14] See, e.g., "Incentives to Innovate and the Decision to Go Public or Private," Daniel Ferreira, Gustavo Manso and Andre Silva (September 2011), at 11, www.mit.edu/~manso/fms.pdf.
[15] See, e.g., "What Do Users of Private Company Financial Statements Want?" Financial Executives Research Foundation, William M. Sinnett and Cheryl de Mesa Graziano (March 2006), http://www.pcfr.org/downloads/05_07_Meet_Materials/FERF_Private_Co_User_Survey.pdf ("Audited financial statements provide comparability, consistency and accuracy").

statements also contributes to efficient and effective analysis of financial reports, and keeps users from being misled.[16] This uniformity not only facilitates investment decisions, but also aids in loan analysis, analysis of capital and debt levels, and other financial information. Creating a separate board to provide GAAP exceptions and special rules for private companies would undermine that consistency by encouraging different financial statements for private versus public corporations. It would also impede users' ability to efficiently evaluate and compare corporations. In the event that a private company proves unscrupulous, disparate accounting practices and records could also impede the investigation and prosecution of fraud or other wrongdoing.[17]

Increasingly mobile capital investment requires ease of analysis and consistency with international accounting standards to attract investors. This proposal moves in the opposite direction and may discourage private sector investment. In recent years, private companies' financial health has been closely tethered to meaningful disclosure and independent audits. Private companies that undergo external audits in compliance with GAAP standards are more likely to secure external funding and obtain lower cost loans.[18] Encouraging less uniform financial reports, with less transparency overall, could act as a disincentive to investment in U.S. private corporations.

Conflicts with International Standards. Still another problem is that the proposal to develop special GAAP rules for private companies represents a major departure from international accounting standards applicable in most countries around the world.

The International Accounting Standards Board (IASB) does not recognize similar exceptions to accounting standards for private companies and does not provide for them in international financial reporting standards. Instead, IASB has developed separate accounting standards for small and medium-sized firms.[19] Drawing accounting distinctions on the basis of whether a company is publicly or privately held would introduce an entirely new set of divergent accounting standards at a time when IASB and FASB have been working to reduce their differences and converge their standards.[20] New accounting rules for private corporations would likely cause substantial convergence problems, given that those standards would apply to the vast majority of U.S. corporations, including some multinationals.

As mentioned earlier, the accounting exceptions and special rules for private corporations would also complicate international investment in U.S. private companies, since those companies could have GAAP exceptions with no international counterparts.[21]

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[16] See, e.g., "New Private Company GAAP on the Horizon," Plante & Moran (February 28, 2011), http://www.plantemoran.com/perspectives/articles/2011/Pages/new-private-company-gaap-on-the-horizon.aspx.
[17] See, e.g., "Corporate Scandal Fallout Affects Private Companies," James Seary, New Jersey Tech News, Vol. 7 Issue 10, (November 1, 2003), http://www.eisneramper.com/corporate-scandal-private-companies.aspx.
[18] See, e.g., "Transparency, Ownership, and Financing Constraints in Private Firms," Ole-Kristian Hope, Wayne B. Thomas, and Dushyantkumar Vyas, Working Papers Series, Social Science Research Network, (October 5, 2009), http://centerforpbbefr.rutgers.edu/20thfea/accountingpapers/session8/hope,%20thomas,%20and% 20vyas.pdf.
[19] See "IASB publishes IFRS for SMEs," International Accounting Standards Board (July 9, 2009), http://www.ifrs.org/News/Press+Releases/IASB+publishes+IFRS+for+SMEs.htm.
[20] "Convergence with the International Accounting Standards Board," Financial Accounting Standards Board, http://www.fasb.org/intl/convergence_iasb.shtml.
[21] See "International Financial Reporting," International Accounting Standards Board, at 131 (2008).

Complications Without Benefits. Private corporations do not need a new council to meet their accounting needs. The Private Company Reporting Committee (PCRC), established in 2006, already "represents all non-public business entities regardless of size" and advises FASB on private company accounting issues.[22] FASB already has formed a team of professionals dedicated to private company accounting issues; created an electronic gateway to facilitate private company analysis of and comment on accounting proposals; and issued a series of accounting standards addressing issues of importance to private corporations.[23] It is also developing a decision-making model to assist in determining when GAAP exceptions or modifications should be made for private corporations.[24] If more is needed, FASB should strengthen the existing advisory process rather than take the unprecedented step of creating a voting "council" for the first time in its history. Creating such a voting council, whose sole aim is to create GAAP exceptions and special rules for private corporations, would disrupt FASB's well-tested approach of considering and balancing a wide range of accounting needs across all sectors, including the needs of financial statement users.

Some supporters of the PCSIC proposal claim that FASB needs a new council so that it can grant more GAAP exceptions for small businesses that don't have the resources to comply with GAAP. This justification for the proposal ignores the fact, however, that many private corporations are large enterprises with ample resources to meet GAAP requirements. Forbes has reported that, in 2011, the 212 most profitable private companies each grossed in excess of $2 billion.[25] Just one of those corporations, Mars Candy Company, for example, collected $30 billion in revenue and employed over 65,000 people.[26] Companies like Mars, Facebook, Bain Capital, and Koch Industries should not be treated as small businesses with limited resources.

Moreover, FASB has already developed mechanisms to address small business concerns about meeting GAAP requirements, including by granting exceptions to GAAP if needed. The Small Business Advisory Committee, for example, was established "to obtain more active involvement by the small business community in the development of financial accounting and reporting standards."[27] If the real concern is addressing the needs of small business, the PCSIC proposal is overly broad, poorly designed, and duplicative.

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[22] "Private Company Financial Reporting Committee," Financial Accounting Standards Board, http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1218220151736.

[23] See FAF Plan to Establish the Private Company Standards Improvement Council, at 3-4; Jeffrey S. Zanzig and Dale L. Flesher, "GAAP Requirements for Nonpublic Companies," The CPA Journal, (May 2006), http://www.nysscpa.org/cpajournal/2006/506/essentials/p40.htm; Ahmed Riahi-Belkaoui, Accounting Theory at 50-51 (2004).

[24] See "Decision-Making Framework for Private Companies," ongoing FASB Project, http://www.fasb.org/cs/ContentServer?site=FASB&c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176158778836 ("The objective of the project is to develop a framework (set of decision criteria) for making decisions about whether and when to adjust the requirements for recognition, measurement, presentation, disclosure, effective dates, and transition methods for financial accounting standards that apply to private companies. The framework is not intended be an entirely new conceptual framework that would lead to fundamentally different financial statements between private companies and public companies.").

[25] "America's Largest Private Companies 2011," Forbes (Nov. 16, 2011), http://www.forbes.com/lists/2011/21/private-companies-11_land.html.

[26] Id.

[27] Financial Accounting Standards Board, "Small Business Advisory Committee (SBAC)," http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1218220151740.

The PCSIC proposal could even increase compliance costs for small businesses, by requiring them to analyze a variety of GAAP exceptions and special rules and determine whether they should utilize them. Many small businesses may not have the accounting expertise to evaluate the various alternatives. The analysis could be particularly complicated for a small business contemplating becoming a public corporation at some point, since it would have to take into consideration the timing and costs of switching its accounting practices from complying with one or more of the possible GAAP exceptions to complying with the actual GAAP standards required of public corporations. Such a switch in accounting practices may entail hefty costs. The result may be that the dual GAAP standards designed to assist private companies may end up disadvantaging small businesses with the least resources to devote to financial reporting.

Still another issue is whether and to what extent the proposed council and new GAAP exceptions would provide any benefits to financial statement users. Reducing consistency between the financial statements of U.S. private corporations versus financial statements that comply with GAAP or international accounting standards, complicating financial analysis, and providing less information overall for private corporations would not help investors, lenders, regulators, or other financial statement users evaluate a private corporation's financial condition or compare its finances to those of similar corporations.

Other Concerns and Unintended Consequences. In addition to undermining GAAP, reducing financial transparency, introducing new conflicts with international accounting standards, and complicating accounting practices, the proposal as currently drafted raises a number of practical problems. For example, it is unclear from the proposal whether the PCSIC members would be compensated for their services either directly or through FASB. If compensated, the new council could impose additional costs on the accounting profession and business community, or divert resources intended for other FASB projects. If PCSIC council members serve without compensation, many accounting practitioners, especially those from the small business and nonprofit sectors, may not have the resources to participate, leaving the council membership to larger private corporations and accounting firms with different priorities and possible conflicts of interest.

Secondly, it is unclear how the proposed PCSIC would interface with the current process for addressing small business concerns. While many private corporations are small in size and have similar concerns to those of other small businesses, some private corporations are large enterprises with very different accounting priorities. As a practical matter, it is unclear how the proposed council is meant to balance those competing concerns, including whether it is intended to delegate small business concerns to the Small Business Advisory Committee and reserve for itself only those accounting issues affecting larger private business concerns. In addition, as a voting rather than advisory body, the PCSIC may feel that its work should take precedence over that of the Small Business Advisory Committee, possibly adding another layer of complexity to the standard-setting process and intensifying competition for FASB's resources and attention. Similar issues apply to how the council would interact with the existing Not-for-Profit Advisory Committee.

Finally, a key unintended consequence of this proposal may be to re-direct scarce resources from improving GAAP standards to designing exceptions to those standards instead. Resources spent on creating GAAP exceptions cannot be used to repair the related GAAP standards and thereby reduce the need for exceptions. The end result may be a growing body of

GAAP exceptions and a steadily weakening set of Generally Accepted Accounting Principles that no longer provide a solid foundation for U.S. accounting standards.

In light of these many concerns, the Financial Accounting Foundation is urged to reconsider its proposal and not to establish the proposed Private Company Standards Improvement Council.

Sincerely,

Carl Levin

Carl Levin
Chairman
Permanent Subcommittee on Investigations