

## Private Company Financial Reporting Committee

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JUDITH H. O'DELL  
Chair

### Meeting Highlights June 25-26, 2009

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Washington, D.C.

All Private Company Financial Reporting Committee (“PCFRC” or “Committee”) members were in attendance, except Mike Cain and John Burzenski.

*Financial Accounting Standards Board (“FASB”) Staff:* Paul Glotzer and Jeff Mechanick

*American Institute of Certified Public Accountants (“AICPA”) Staff:* Bob Durak and Dan Noll

#### **FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (“FIN 48”)**

The PCFRC reviewed proposed FASB Staff Position (“FSP”) FIN 48-d, *Application Guidance for Pass-through Entities and Tax-Exempt Not-for-Profit Entities and Disclosure Modifications for Nonpublic Entities*. The PCFRC continues to have concerns about the usefulness of FIN No. 48 information in the private company sector. Nevertheless, the PCFRC is appreciative of the FASB’s development of the proposed FSP and believes that the implementation guidance and disclosure relief offered by the proposed FSP will be well received among private company constituents.

The committee decided to issue a comment letter on the proposed FSP, making the following points:

- The PCFRC is of the opinion that the principles-based approach taken by the FASB in providing implementation guidance to pass-through entities is operational and provides an effective and adequate framework for pass-through entities. However, the PCFRC believes that the FASB should make clear in the proposed FSP that the accounting for transactions with owners has not changed and such transactions should be accounted for under existing applicable standards.
- Guidance on whether or not a tax is an income tax is needed, particularly in response to the emerging trend in state taxation toward taxes that are difficult to classify as income tax or non-income tax. The PCFRC will recommend that the FASB initiate a separate project to consider the definition of an income tax.
- The PCFRC agrees with the modification to the disclosure requirements in the proposed FSP.
- The PCFRC has noted that some comment letters submitted on the proposed FSP suggest that the FASB add a requirement for nonpublic entities to disclose the total amount of unrecognized tax benefits as of the balance sheet date. The PCFRC is strongly opposed to adding this additional disclosure requirement. The

user representatives on the PCFRC are in agreement that the total amount of unrecognized tax benefits is not useful information and having knowledge of that amount would not affect their decision making and analytics. Private company users are interested in gaining assurance that an entity has recorded all material liabilities related to income taxes. Information about the total amount of unrecognized tax benefits is not actionable to those users.

### **Revenue Recognition Preliminary Views**

The PCFRC spent considerable time reviewing and discussing the proposed requirements contained in FASB's Revenue Recognition Preliminary Views. This is a key convergence project which could have substantial effects on private company financial reporting. The session began with a conference call with representatives from the Construction Financial Management Association. These representatives voiced their concern over the proposed changes to construction contract accounting and the related existing guidance of SOP 81-1. After the call, the PCFRC developed its comment points on the Preliminary Views. The key comments are as follows:

- Private company financial statement users, including lenders and sureties, have the following concerns:
  - The proposed guidance in the Preliminary Views will cause existing revenue recognition patterns to change unnecessarily, which will needlessly impair comparability and analysis. Additionally, the proposed guidance appears capable of creating diversity in application, further impairing comparability.
  - Lacking the current body of long-term contract accounting literature, the proposed revenue recognition principles could make the manipulation and structuring of long-term contracts easier, as part of efforts to understate or overstate revenue, and could lead to abuse.
  - The decision-usefulness of financial information may be weakened if the current percentage-of-completion based accounting model is replaced by the proposals in the Preliminary Views. Allowing different gross profit percentages for various performance obligations in a contract, combined with the fact that one does not adjust for changes in cost estimates unless a contract is deemed "onerous" will result in users not being able to estimate the remaining cost to complete a contract and related revenue to be recognized.
- The proposed revenue recognition guidance in the Preliminary Views has generated considerable concern within the construction industry. Many years of work by standard setters and the accounting profession have crafted the existing standards and guidance on accounting for construction contracts. This existing literature is well-known and understood by private company financial statement users, preparers, and CPA practitioners. Although existing guidance needs to be updated to address developments within the construction industry, it generates a high level of consistent financial reporting and generally reflects the underlying economics relating to the complicated and dynamic nature of contracts often found in the construction industry. The Preliminary Views does not appear to

provide an adequate level of guidance to deal with the complexities inherent in accounting for construction contracts and other long-term contracts. As such, the PCFRC recommends that the FASB carefully consider the need to provide additional guidance on accounting for long-term contracts with differing characteristics and performance obligations.

- Some of the examples in the Preliminary Views, especially those related to construction contracts, are too simplistic and do not reflect the complex and dynamic reality of long-term contracts. The PCFRC recommends that the FASB utilize real-life, practical examples of long-term contracts that private companies encounter in the construction industry and other industries and apply the proposed revenue recognition model to those examples. In doing so, the FASB will be better able to determine whether the proposed model is operational and effective at handling the unique aspects of recognizing revenue on long-term contracts. Applying the proposed model to real-life examples will also indicate whether the proposed guidance is effective at generating consistent financial information that is decision useful for private company users.
- Private companies involved with long-term contracts will face major difficulties and challenges in applying the concepts of transferring control, the continuous transfer of control, and identifying separate performance obligations. These concepts are in need of significant clarification and development

### **Lease Accounting Preliminary Views**

The PCFRC developed its comment letter points on the FASB's Lease Accounting Preliminary Views, also a key convergence project that could substantially affect private company financial reporting. Key points developed by the Committee are:

1. The PCFRC recommends that the FASB address the lessor side of lease accounting in conjunction with the lessee side. Having both sides of lease accounting resolved at the same time is essential in the private company sector. This is because of the prevalence of related party leasing arrangements in the private company sector, often involving variable interest entities. Without resolving the lessor accounting along with the lessee accounting, uncertainty and misunderstanding may occur in trying to account for and report on these related party arrangements.
2. On the basis of cost-benefit considerations, the PCFRC recommends that arrangements in which the most likely term, including renewal clauses, is twelve months or less should be excluded from the scope of the lease project.
3. Describing the decrease in value of the right-of-use asset as rental expense is not supported by the PCFRC. The use of the rental expense description in conjunction with the recording of the obligation to make lease payments as a liability may affect key financial metrics such as the debt-to-EBITDA (earnings before interest, taxes, depreciation and amortization) ratio, which is an important measure in the private company sector.

4. The PCFRC recommends that amounts payable under contingent rental agreements and residual value guarantees should not be included in the lessee's obligation and should only be recognized when payment is probable.
5. The PCFRC recommends that the FASB consider adding guidance to the proposed standard that would address the accounting for leases with variable payments due to something other than a contingency or an index.

### **Discussion with FAF Chairman**

In a closed-door session, the PCFRC discussed the work of the Committee with John Brennan, Financial Accounting Foundation Chairman. PCFRC members informed Mr. Brennan about the Committee's work and achievements to date and its working relationship with the FASB. In addition, areas for improvement were also discussed with Mr. Brennan.

### **IFRS for SMEs**

Recent developments related to the International Financial Reporting Standard for Small and Medium Sized Entities (IFRS for SMEs), and private company accounting efforts in other countries were discussed by the Committee. With the upcoming final issuance of IFRS for SMEs (released on July 9, 2009), the PCFRC decided to conduct a detailed review of the new standard. To that end, individual sections of IFRS for SMEs were divided among PCFRC members for their review. The goal of this review is to compare IFRS for SMEs to existing U.S. GAAP and assess whether IFRS for SMEs provides private company financial statement users with adequate and relevant information. This work will be performed by the PCFRC members in time for the next PCFRC meeting in August, where the reviews of the individual IFRS for SMEs sections will be addressed.

### **Improving Disclosures about Fair Value Measurements**

This FASB project may consider additional disclosures, such as (a) the sensitivity of fair value measurements to changes in assumptions and (b) transfers between the three levels of the fair value hierarchy. PCFRC members discussed the project and noted that level 3 fair value measurements (as defined in FASB ASC section 820 (FASB Statement 157)) are not uncommon at private companies. That being the case, the PCFRC will continue to monitor this project and consider communicating to FASB staff the prevalence of level 3 measurements at private companies, the needs of private company financial statement users in this area, and the need for the FASB to be cautious and not burden private companies with increased disclosure requirements that will not be relevant and useful.

### **Discussion with FASB Staff, Jeffrey Mechanick**

Jeff Mechanick, FASB Assistant Director, explained his role related to private company accounting at the FASB during a phone call with the PCFRC. The PCFRC invited Jeff to attend its future meetings, as his schedule permits.

### **FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities***

On June 12, 2009, the FASB issued Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*. During the development of this project, the PCFRC recommended to the FASB that additional examples be included in the final standard to address common situations in the private company sector. The PCFRC was disappointed that FASB Statement No. 167 did not contain those examples. As a follow-up, the Committee asked FASB staff at the meeting to explore ways that private company-related examples could be provided by the FASB.

### **Monitoring of FASB Projects**

The committee, in conjunction with FASB staff, reviewed progress that has been made on various FASB projects, which may affect private company financial reporting. In particular, the PCFRC discussed recent developments related to the FASB's Preliminary Views, *Financial Instruments with Characteristics of Equity* and the Loan Loss Disclosure project.

### **FASB Codification**

FASB staff gave a presentation to the PCFRC about the new FASB Standards Codification, which is now the single source of authoritative U.S. GAAP. The Committee logged on to the Codification and explored its features and how the Codification works

### **Next PCFRC Meetings**

The PCFRC will hold its next meeting on August 6-7, 2009 in Pittsburgh, Pennsylvania. Beyond August, the PCFRC has set the following tentative meeting dates and places.

October 22-23, 2009 – Charlotte, North Carolina

December 3-4, 2009 – Norwalk, Connecticut

These dates and places are subject to change.