Why Public Companies Need to Know About Private Company GAAP

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During the last year or so, the Financial Accounting Standards Board (FASB) has issued several Accounting Standards Updates (ASUs) that modify Generally Accepted Accounting Principles (GAAP) for organizations that aren't considered "public business entities" within GAAP's definition of such a company.

Although public companies need not be concerned about private company GAAP in preparing their own financial statements, the difference can have a huge impact on certain corporate activities, especially those involving potential acquisitions of private companies.

In addition, private companies contemplating an initial public offering (IPO) should think twice before adopting any of the accounting alternatives offered by the newly issued and future ASUs. The need to convert their financial statements to "public company GAAP" can delay or disrupt the IPO process.

Background

Although not legally required, many private companies prepare audited, GAAP-compliant financial statements to meet the needs of lenders, regulators and other financial statement users. For years, many in the accounting community have held the belief that, for private companies, the limited benefits provided by certain aspects of GAAP don't justify the added complexity and cost. Particularly within the past few years, this topic has generated much debate given the fact that various new standards issued are increasingly complex in nature.

To address this issue, in 2012 the Financial Accounting Foundation (FAF) — FASB's parent organization — established the Private Company Council (PCC). Its mission is to identify and recommend changes to GAAP that respond to the needs of private companies and their financial statement users.

FAF rejected the notion of a separate private company GAAP administered by an autonomous board with standard-setting power. Instead, PCC-recommended modifications or exceptions for private companies are reviewed by FASB. If FASB endorses the recommendations, then the changes are incorporated into GAAP.

So far, FASB has issued four ASUs based on the PCC's recommendations:

1. **ASU 2014-02** — Gives private companies the option to amortize acquired goodwill over a period of 10 years or less and test goodwill for impairment only if there's a triggering event. Public companies may not amortize goodwill and must test it for impairment at least annually.
2. **ASU 2014-03** — Simplifies accounting for certain interest rate swaps for private companies other than financial institutions.
3. **ASU 2014-07** — Allows private companies to elect an alternative option of not applying variable interest entity guidance to a lessor if certain provisions are present.
4. **ASU 2014-18** — Allows private companies to elect an alternative to not recognize separately from goodwill.

Effect On Public Companies

There are several situations in which a public company may be required to include a private company's financial statements in its SEC filings. They include:

- Significant businesses or groups of businesses the company has acquired or is likely to acquire,
- Significant lessees or guarantors, and
- Equity method investees — that is, businesses in which a public company has equity investments that fall short of a controlling interest but are sufficient to provide it with "significant influence."

For purposes of financial statements filed with the SEC, these companies are considered public business entities. If they've adopted any of the PCC's modifications or exceptions for other purposes, their financial statements must be converted to comply with public company GAAP. So, if a public company acquires a private company that follows private company GAAP, it likely will need to have the target's financial statements redrafted, restated and reaudited, ideally before it consummates the transaction.

Depending on the company's size and the significance of the acquisition, it may have to furnish up to three years of financial statements for the target.

Be Prepared

If your company is involved in acquisitions or other transactions with private companies, find out early in the process if they've adopted any private company GAAP provisions. If they have, consider the effort needed to convert their financial statements to public company GAAP as part of your due diligence.

What's A Public Business Entity?

For purposes of private company Generally Accepted Accounting Principles (GAAP), "public business entities" generally include companies required under U.S. securities laws to make filings with the SEC or another regulatory agency. Companies that issue publicly traded debt and certain other companies are required to prepare GAAP-compliant financial statements and make them publicly available.

In addition, a company is a public business entity — for SEC purposes only — if its financial statements are included in another company's SEC filings.