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CL #41

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Technical Director - File Reference 1310-100  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

Dear FASB:

This is our response to the Invitation to Comment on the proposal titled "Enhancing the Financial Accounting and Reporting Standard - Setting Process for Private Companies." This issue is of particular interest to our firm since our firm's entire client base consists of non-public enterprises, which are typically family-owned. The Invitation to Comment refers to such enterprises as "private companies", and we will use that same terminology in this response.

Like the private companies that we service, we are a very modest-size accounting firm. Accordingly, responding to your Invitation to Comment would ordinarily be an extremely rare occurrence. We are making this exception due to the importance of the issue at hand. Despite our modest size, our entire organization is dedicated to the goal of the strictest adherence to the professional standards and the various accounting rules, and we consider the financial statements that we produce to be of the highest possible quality. This is a point of pride to our firm. We are explaining this simply to try to relay to you our point of reference in viewing this issue of accounting standards for private companies.

To begin our discussion, as a general comment, we agree that there should **not** be two distinctly separate sets of accounting standards, one for public companies and one for private companies. That would just be far too confusing to everyone concerned. Instead, we agree with the proposal that the standard-setting process should simply allow modifications to the standards (both ones that currently exist and ones to be issued in the future) that address the needs of private companies.

We also agree that the basic flaw in the current standard-setting process probably originates from the fact that both private companies and the small accounting firms that service them rarely participate in the standard-setting process. We realize that this situation was never purposefully intended by the FASB. On the contrary, we recognize that the FASB has taken great efforts to obtain input from as many sources as possible as part of its standard-setting process. It is simply a given state of affairs that such input from small private companies and the small accounting firms that service them will be rare indeed. First, small private businesses almost certainly lack the sophistication to comprehend and analyze proposed accounting standards, even if there was an attempt to do so. Second, both small private companies and small accounting firms typically find themselves completely immersed in the struggle for basic day-to-day survival. This does not lend itself much opportunity to evaluate and comment upon proposed accounting standards. No matter what the cause, the situation that results is that small private companies and small accounting firms are greatly under-represented in the standard-setting process.

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The direct effect of this is that the current standard-setting process seems to be largely participated in by representatives of large public companies, large national accounting firms, and elite members of academia. Even though such people are certainly well-intentioned and they undoubtedly do their best to take into account the effects of any proposed standards on private companies, it is just highly improbable that the best interests of small private companies will be truly represented under the current system.

Therefore, the proposal to set up a committee charged with the sole responsibility of bringing to the standard-setting process the interests of, and effects on, private companies is definitely a step in the right direction. It will be interesting to see if this change to the standard-setting process (assuming it goes into effect) results in a true impact on the actual results of that process.

There is no question that the world has become more complicated, so there is no mystery as to why some of the recent accounting standards have similarly become complex as well. However, we must always keep in mind that the goal of accounting standards is to set the rules so that GAAP-based financial statements tell a story about the financial condition and operations of the business enterprise. However, if that storyline becomes too complicated and too convoluted the reader may no longer be able to follow along. When that happens, the usefulness of the financial statements is lost. We realize that a large complex business enterprise will undoubtedly have complex financial statements. But, similarly, shouldn't a small, simple business have relatively simple financial statements? We sense that recent standards have started to stray far from that basic principle of simplicity.

So far, our discussion has been rather esoteric, dealing in vague generalities. Therefore, to breathe some life into this discussion, we want to use some examples of pronouncements that may have lost touch with private businesses and the users of their financial statements. Our goal is not to criticize specific standards, but rather to simply shed some light on the viewpoint of those pronouncements from a private company perspective.

The first accounting pronouncement that was issued that seemed to ignore the viewpoint of private companies was Statement No. 87, dealing with accounting for defined benefit pension plans. I have yet to meet the owner of a private company who understands the accounting rules involved. Similarly, the users of the financial statements of private companies (lenders, bonding companies, etc.) are equally perplexed by themselves. Fortunately, defined benefit pension plans are fairly rare among private companies. Therefore, when this pronouncement was issued (many years ago now) absolutely all of our private company clients ignored the new rules and began issuing "GAAP departure" financial statements. Although this did an adequate job of solving the problem, one could definitely sense that accounting standards had started down a new path, a path that was leading away from standards that are practical and meaningful to private companies.

The next example of an accounting pronouncement that appears to completely ignore the viewpoint of private companies is Statement No. 133 that established new rules for accounting for derivative financial instruments. I think that the world of private companies felt as though it was completely blindsided by these new rules. When certain institutions racked up massive losses on account of their investments in derivative financial products, it seemed as though these new rules were welcomed by everyone to bring the accounting rules into line with the economics of these rather risky investments. Private companies were totally unconcerned with these new rules since they felt that they never traded in derivatives. The thinking by private companies was that "this doesn't apply to me." Unfortunately, it wasn't until the pronouncement was already

issued that private companies realized that this complicated and far-reaching pronouncement actually *does* apply to many of them. You see, many banks began issuing their commercial loans only with variable interest rates. Accordingly, the only way for a borrower to obtain a fixed interest rate (a very popular feature among private companies) was to enter into an interest rate swap, unaware that such swaps are actually derivative financial instruments. Accordingly, Earl's Machine Shop (a fictitious business enterprise) finds itself with a loan agreement requiring GAAP financial statements forcing that little company into compliance with a very complex accounting pronouncement. Every year, Earl's Machine Shop now hands financial statements to their bank that include a statement of other comprehensive income, a statement that the Company's owner does not comprehend at all. Poor Earl, all he wanted was to fix the interest rate on his loan. He had no idea what he was getting into.

Another example of an accounting pronouncement that proved troublesome to private companies is Statement No. 142 that changed the accounting rules for goodwill. Yes, goodwill is an asset that *can* be found on the financial statements of many private companies. Even little companies sometimes acquire other businesses for more than the value of the identifiable assets. Once again, Earl's Machine Shop may find itself with \$25,000 of goodwill on its books, an amount that is material to its modest financial statements, but an amount that doesn't come anywhere close to justifying annual business valuations to determine if the goodwill has been impaired. Again, poor Earl would love to see a simple sentence added to the accounting pronouncement that says something to the effect that "private companies may elect to amortize goodwill over a period not to exceed X years." Wait, isn't that what the rules *used* to say? For private companies, those truly were the good old days. We realize that adding such a clause to the accounting pronouncement creates two optional treatments for the same item. But, again, in the world of private companies, such concerns simply do *not* matter, not to the private companies, nor to the users of their financial statements.

The final example we would like to mention can be seen as the straw that broke the proverbial camel's back, and this accounting pronouncement is nothing more than a FASB Interpretation. Yes, we are referring here to FIN 46, which introduced the world to something called "variable interest entities." Trust us when we say that private companies have no idea what a variable interest entity is. Unfortunately, this accounting pronouncement applies to a situation that is common among private companies. It is a very common practice for the owners of private companies to own the commercial real estate through separate limited liability companies. Such real estate is typically acquired through a mortgage that is guaranteed by the private company and/or its owner. This throws such private companies directly into the world of FIN 46. The problem is that FIN 46 is totally incomprehensible to both the owners of private companies *and* their bankers. In fact, many of the banks whose loan agreements require GAAP financial statements are the same banks who say that they *don't* want the real estate entity "mixed in" with the operating company since the two entities are financed with different banks. The result is that our firm has never seen so many "GAAP departure" financial statements before. This is an undeniable indication that GAAP has lost its relevance to private companies.

So what are these private companies to do? What options are available to them? We have pointed out one option already - using GAAP departures in the financial statements. The problem is what happens if there is more than one GAAP departure? What if there are two departures? What about three? If Earl's Machine Shop has an interest rate swap, and it guarantees the debt of its brother/sister real estate entity, and it has some goodwill, is the use of GAAP departures still an option? If financial statements have three significant GAAP departures, are those financial

June 26, 2006

Page 4

statements even GAAP based anymore? Or is the company using some other underlying basis of accounting? These truly are real life questions.

A common answer to this question that is often heard coming from academia is to just use tax basis financial statements. Unfortunately, this is a well-intended but ignorant response that demonstrates just how out of touch such members of academia truly are. You see, recent tax law changes have seen such things as increasing the annual (Section 179) expensing of assets to over \$100,000 coupled with a very generous ability to use the cash basis of accounting. Hence, whereas once upon a time tax basis financial statements may have been a viable alternative, is a set of financial statements that show no accounts receivable and little or no fixed assets of any use to anyone, especially a lending institution? The answer is that such statements would obviously be useless. Therefore, a private company attempting to resolve their financial statement dilemma by using the tax basis of accounting would need to use "tax basis departures" to make those statements at all useful. We think you can readily see that this is quickly getting rather absurd.

Please, we hope that you listen to us, as ours is a voice from the trenches. We hope that we never see the day when we help prepare financial statements for a private company that will need to include an index of the dozen or so GAAP departures. Reality is that the CPAs in our firm have seen a metamorphosis in private company financial statements from a time where GAAP departures were so rare they were almost unheard of, to the present where they are absolutely commonplace. We see this as an apparent and undeniable vote from the business community of private companies that the accounting rules have lost touch with that community.

Therefore, we applaud your current efforts with this proposal. And we truly look forward to the possibility that future complex accounting pronouncements will include an escape clause for private companies to elect a simpler approach that is coupled with appropriate disclosures. Surprisingly, we have found that rules that require additional footnote disclosures are not necessarily unwelcome. Our experience has been that it is extremely rare for a private company to actually object to required footnote disclosures. True, sometimes those disclosures may seem downright silly to private company owners (such as the "use of estimates" disclosure), but they have generally not been found objectionable. Certainly, we would not expect such owners to pose problems with the disclosure of their choice of the simpler (less costly) method of accounting when such an option is allowed under GAAP.

Our firm does appreciate your Invitation to Comment, and we truly appreciate the fact that the comment period extends well outside of tax season. (As a side comment, if you really do want comments on future pronouncements from either private companies or small accounting firms, your comment period should stay away from December through April.) Furthermore, we hope that this letter before you is given honest consideration. Thank you.

Very truly yours,



David E. Andrysko, CPA



Anissa M. Shear, CPA