CHANGES TO ACCOUNTING FOR INVESTMENTS AND THE EMERGENCE OF PRIVATE COMPANY FINANCIAL REPORTING STANDARDS – ISSUES, CHALLENGES, AND OPPORTUNITIES

Marianne L. James, California State University, Los Angeles

CASE DESCRIPTION

The primary subject matter of this case concerns proposed financial accounting and reporting changes that will affect virtually all U.S. public and private companies. The case addresses proposed significant changes to the measurement and recognition of investments and the emergence of private company financial reporting standards. Secondary, required financial reporting changes that must be implemented starting with the 2012 reporting periods are also briefly addressed. The main focus of this case is on the technical accounting changes and their likely financial statement effect, as well as short-term and long-term strategic decisions that may substantially be influenced by these significant changes.

This case has a difficulty level of three to four and can be taught in about 40 minutes. Approximately four hours of outside preparation is necessary for students to fully address the issues, concepts, and suggested assignments. The assignments include both case-specific questions and questions requiring research. This case can be utilized in an intermediate accounting course, but also can be utilized in a graduate level course focusing primarily on the strategic issues. The case may enhance students' technical knowledge and their critical thinking, analytical, research and communication skills.

CASE SYNOPSIS

Significant changes to financial accounting and reporting during the next five years will affect nearly all private and public entities. One of the proposed changes that likely will affect most entities involves accounting for investments. As part of their convergence project, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are revising the accounting rules governing the recognition and measurement of investments, while attempting to develop global consistency. In addition, the Blue Ribbon Panel on Standard Setting for Private Companies (BRP) recommended to the Financial Accounting Foundation (FAF) that accounting standards for non-public entities should be developed. While this may enhance the usefulness of financial reporting by private companies, it likely will cause comparability issues between private and public companies, particularly in light of the likely implementation of IFRS by public companies during the next five to seven years. In addition, since many private companies eventually become public and public companies frequently invest in or acquire private entities, it can also affect investment and acquisition strategies, as well as *financing decisions. Thus, the two issues – accounting for investments and private company financial reporting – are interrelated.*

This case addresses technical accounting issues as well as the strategic issues that may affect companies' investment and acquisition strategies. The introduction to the case provides brief background on the topics. The case was developed for an intermediate accounting course, but can also be used in a more advanced course focusing primarily on the strategic issue. The suggested assignments include case-specific as well as research questions. All questions are independent to allow for maximum flexibility; the case can be assigned as a group or as an individual project. Assigning this case may enhance students' critical thinking, research, and communication skills; as well as their technical accounting knowledge.

INTRODUCTION AND BACKGROUND

Most companies carry investments on their balance sheets. For example, based on information provided by *Accounting Trends and Techniques*, 92% of the 500 entities surveyed annually by the American Institute of CPAs included non-current investments on their 2009 balance sheets (AICPA, 2010). In addition, 35% of the surveyed companies reported current investments in marketable securities on their balance sheets (AICPA, 2010). The most common types of investments involve equity securities, corporate bonds, hybrids, and derivatives. Equity securities, which make up 63% of the surveyed entities' non-current investments (AICPA, 2010) include both publicly traded and privately-held ownership interest in other companies.

The reasons for purchasing investments vary depending on the investors' short-term and long-term objectives and strategies. Some companies view investments as the most effective and profitable method of utilizing excess cash available from successful operations or seasonal business; other companies may be primarily motivated by the desire to realize short-term gains; while other companies may purchase investment in order to accumulate the necessary funds needed for long-term projects. For some entities, investments provide the means to acquire sufficient ownership in another entity with the goal to influence or even control the decisions of the entity and to benefit from their operations. Many entities have multiple investment objectives.

Current accounting rules in the U.S. reflect these different motivations and investment objectives. Under current Generally Accepted Accounting Standards (GAAP), many investments must be measured and reported at fair market value, depending primarily on the type of financial assets and the company's investment objectives. Investments that provide the investor with significant influence over the investee's operations and strategic decisions must be measured and reported using the equity method of accounting, while controlling interest in another entity typically requires consolidation of the financial statements.

With the advent of very complex financial instruments, and the complexity of current accounting rules, the FASB and the IASB have undertaken an extensive joint project to revise accounting and reporting for all financial assets. As part of their efforts, in 2010, FASB issued a proposed accounting standards update (FASB, 2010) that would substantially change accounting for investments for many entities and likely affect companies' income and financial position. Since issuing their proposed accounting standards update (also referred to as exposure draft) and after considering the 2,814 letters received during the comment period, FASB has reached some additional tentative decisions. New requirements under the exposure draft and additional decisions reached to date are incorporated in this case.

While changes to accounting for investments (and other financial assets) will affect the financial statements of many entities, even more pervasive changes are still on the horizon. These changes will affect both public and private companies and financial statement users, and may affect entities' investing, acquisition, and financing strategies.

For some time, non-public companies, many of which prepare financial statements consistent with U.S. GAAP and thus utilize FASB issued standards, and their financial statement users have voiced concern regarding the cost and relevance of preparing reports consistent with U.S. GAAP. This led to the formation of the Private Company Financial Reporting Committee (PCFRC) entrusted with the mission to explore the financial reporting needs of private entities and their financial statement users. Additional momentum for their efforts arose when the Securities and Exchange Commission (SEC) started considering the adoption of IFRS by U.S. public companies. Currently, it appears likely that the SEC will require at least some degree of IFRS implementation by U.S. public companies.

With nearly 130 nations currently accepting or requiring the use of IFRS, multi-national entities are expected to benefit most by an integration of IFRS since they tend to have subsidiaries that are already utilizing IFRS. For these companies, the use of IFRS would significantly simplify their financial reporting process, may make the process more efficient, and could facilitate easier access to global financial markets.

While public multi-national entities likely will achieve financial reporting efficiencies, the potential benefit is much less certain for private companies. Use of IFRS by private companies could place a significant burden on these companies. This has raised concern from private companies, policy makers, accounting groups, and others concerned about financial reporting issues.

In response to concerns about financial reporting by private companies, the American Institute of CPAs (AICPA), the Financial Accounting Foundation (FAF), and the National Association of State Boards of Accountancy (NASBA) sponsored a Blue Ribbon Panel on Standard Setting for Private Companies (BRP). The objective of the panel was to (a) consider the needs of private company financial statement users, (b) consider how accounting standards can meet those needs, and (c) make a recommendation the FAF Board of Trustees (BRP, 2011).

During January 2011, the BRP issued its final report and recommendations (BRP, 2011). These recommendations likely will lead to significant changes in financial reporting and significant challenges and opportunities that may affect strategic decisions made by private as well as public companies. It may lead to very substantial financial reporting differences between private and public companies and may also strongly influence investment, acquisition, and other strategic decisions. This case addresses many of these issues, as well as those related to changes in the recognition and measurement of investments.

FORTSCHRITT COMPANY

Karin Felder is the Chief Financial Officer (CFO) of Fortschritt Company, a successful professional networking company founded in 1996. The company went public in 2010. Initially, the company grew through internal innovation, its services capturing a significant percentage of the industry's market share in the U.S. as well as abroad. After its successful initial public offering (IPO), the company's board of directors voted to pursue further growth by acquiring several competitors during the next five years and authorized management to explore diversification opportunities related to the growing on-line games market.

FORTSCHRITT'S OVERALL FINANCIAL POSITION

After initial financial difficulties, Fortschritt Company has been quite successful and its revenue and income have increased consistently during the past few years. For the quarter ended June 30, 2011, the company earned net income of $7.5 million and achieved revenue of $91 million. The company has accumulated a significant amount of cash and cash equivalents from the proceeds of its IPO and from successful operations. The company invested a significant portion of the IPO proceeds in short-term and long-term investments in equity and debt securities of other entities. In addition, the company recently acquired a significant ownership interest in two start-up companies. More detail about the company's investments is shown below.

FORTSCHRITT'S INVESTMENTS

Fortschritt Company's most recent financial statement notes show that the company classified 35% of its investments as current and 65% as non-current. Eighty percent of the current investments are classified as "available for sale" (AFS) securities and carried at fair value, the rest is classified as "held to maturity" and reported at amortized cost. About 41% of the company's non-current investments consist of equity shares of public companies and are accounted for under the equity method, about 31% are measured and reported at fair value, and about 28% relate to ownership interest in privately held entities and are recognized at cost. Tables 1 and 2 provide additional information about the company's cash and equivalents and its current and non-current investments.

Table 1
CASH, CASH EQUIVALENTS, AND SHORT-TERM INVESTMENTS

In thousands	Quarter ended, 6/30/2011
Cash	$24,000
Cash equivalents: money market funds, commercial papers and other short-term obligations	$50,000
Investments in Marketable securities:	
Available for sale (at fair market value):	$13,800
Held to maturity (at amortized cost)	3,450
Total cash, cash equivalents and short-term investments	$91,250

Table 2 NON-CURRENT INVESTMENTS	
In thousands	**Quarter ended, 6/30/2011**
Available for Sale Securities (at fair market value)	$10,000
Equity method investments	13,100
Cost method investments	9,000
Total non-current investments	$32,100

FUTURE ACQUISITIONS

To support its expansion and growth objectives, the company is planning to acquire several privately held start-up companies during the next five years. The company is currently researching potential acquisition targets that are operating in the on-line games industry as well as several of its smaller competitors. The company plans to utilize its significant amount of cash and cash equivalents and cash flows from its expected continuing positive operations to finance the majority of these acquisitions.

FINANCIAL REPORTING ISSUES

On October 12, 2011, Karin Felder prepares for her weekly meeting with the company's Chief Executive Officer (CEO), Robert Meier, and Chief Operating Officer (COO), Marion Kunze, to discuss financial reporting issues as well as the company's short-term and long-term strategic plans that will impact the financial results of the company. Karin, holds active CPA and CMA licenses and is very knowledgeable not only about U.S. GAAP but also IFRS; she is proactive and keeps current on new developments both in terms of global and U.S. financial reporting issues. As a frequent speaker for a continuing professional education program at the state university, she regularly uses her extensive knowledge to help accounting professionals keep informed about current and emerging financial accounting and reporting issues. Her GAAP update and FASB/IASB convergence projects seminars are always well received. She also regularly participates in professional and academic meetings and conferences to exchange ideas with colleagues both in industry and academia.

Karin has been instrumental in preparing her company and its accounting staff for the likely adoption of IFRS. She is very knowledgeable about the FASB/IASB convergence projects, which will change IFRS as well as U.S. GAAP. She is also aware of the movement toward private company financial reporting standards. While she recognizes the advantages of a simpler set of accounting standards for private entities, she is aware of the challenges it can hold for public and private companies. Karin is especially concerned about the potential effects on Fortschritt's future acquisitions and the additional financial reporting issues it may entail for the company when it acquires private entities in the future.

MEETING AGENDA

Karin plans to provide Robert and Marion with updates of current and future financial reporting issues and discuss the potential effect of accounting changes on the company's strategic plans. The following shows the topics she placed on her informal agenda for the upcoming meeting with the CEO and COO.

Karin's Informal Agenda

1. Financial reporting changes required for the 2012 fiscal year:
   a. Comprehensive income
   b. Fair value
2. Proposed changes to accounting for investments:
   a. Current status of changes in accounting for investments
   b. Potential impact on Fortschritt Company's financial statements
3. Private company financial reporting
   a. Current status
   b. Implications of future acquisitions of privately held entities
4. IFRS readiness update

KARIN'S MEETING WITH THE CEO AND COO

On October 14, 2011, the company's CEO, COO, and Karin (the CFO) meet to discuss long-term and short-term strategies to achieve the company's long-term growth objectives as well as financial reporting issues that may affect these goals. Before discussing these issues, Karin first provides Marion and Robert with an update on changes that will affect the 2012 and subsequent accounting periods.

First, she explains that consistent with a recently issued accounting standards update (FASB, ASU-2011-05) the option of presenting comprehensive income as part of the changes in stockholders' equity statement has been eliminated. Instead, comprehensive income must be presented either as a combined income-comprehensive income statements, or, alternatively, as a separate statement that details other comprehensive income and also shows the sum of total comprehensive income. This separate statement must be presented immediately following the income statement. Karin favors the one statement approach, which she views as the preferred format and perceives as the long-term financial reporting trend.

The CEO and COO agree with Karin's reporting preference and Karin proceeds to update them on another recently issued FASB standard on fair values (FASB ASC 2011-04). Karin explains that the new standard will not change the items to which fair value is applied, but rather redefines fair value, converges the terminology and measurement of fair value between U.S. GAAP and IFRS, and requires additional disclosures. The new standard also specifies that the "highest and best use" concept of applying fair value is relevant only to non-financial assets. With respect to disclosures, the new standard requires that companies disclose quantitative data regarding fair value measurement inputs and include information about the sensitivity of changes in these inputs on fair value. Currently, Fortschritt Company's only assets that are measured at fair value are financial assets. In addition, Fortschritt's financial statement notes already include the necessary additional disclosures.

After the brief update on 2012 fiscal year financial reporting changes, the executives discuss proposed major changes that likely will affect Fortschritt Company.

INVESTMENTS

The CEO is concerned about recent fluctuations in the market value of the company's investments and the effect of these fluctuations on the company's financial position. He has heard that FASB proposed changes in accounting for investments and asks Karin to comment on this issue.

Karin explains that FASB is revising its accounting standards on financial instruments, which likely will require that nearly all of the company's current investments and a significant portion of its non-current investments will have to be measured and recognized at market value with the corresponding market adjustments recognized in income. In addition, since this is part of the FASB/IASB convergence efforts and the IASB already issued similar requirements, even if the company were to implement IFRS, the overall results would be very similar. Since changes in the market value of investments would affect the company's net income, volatile financial markets may cause significant fluctuations in income.

Prior to the meeting, Karin prepared a brief handout that summarizes current applicable GAAP with respect to investment securities, as well as the most significant changes that would affect the company's reporting of its investments.

Table 3
CURRENT CLASSIFICATION AND MEASUREMENT OF MARKETABLE SECURITIES – INVESTMENTS LACKING SIGNIFICANT INFLUENCE

Initial Classification	Investment Objective	Subsequent Measurement and Recognition
Debt Securities Held to Maturity	Investor entity intends to hold debt security until it matures	Amortized Cost
Available for Sale Securities	Marketable debt or equity securities that are not classified as debt securities held to maturity or trading securities	Fair value, with unrealized gains and losses recognized as part of stockholders equity (accumulated other comprehensive income)
Trading Securities (Fortschritt currently does not have an investment strategy consistent with this classification)	Short-term investments that investor company holds primarily with a short-term gain objective	Fair value, with unrealized gains and losses recognized as part of income
Subsequent changes in categories	If investment objective changes	Changes in categories are permitted. May lead to recognition of gains and losses in income, depending on the specific change.
Sale of investment	De-recognition of investment	All realized gains and losses are recognized in income

After briefly reviewing the current classifications and measurement of the company's investments, Karin shows the CEO and COO how the classification and measurement of the company's current investments, which do not involve significant influence over the investees' operations, would change under the FASB proposed accounting standards update. She shares the following table (table 4) with Marion and Robert.

Table 4
PROPOSED CLASSIFICATION AND MEASUREMENT OF MARKETABLE SECURITIES

Initial Classification and Measurement	Requirements	Subsequent Measurement and Recognition
Fair value through net income (FV-NI)	Default category unless specific criteria for other classification are a met. All equity securities are measured at FV-NI	Fair value; gains and losses from changes in fair value are recognized in income statement
Fair value through other comprehensive income	Business strategy requirements: At acquisition, cash is invested in order to (1) maximize returns from collection of contractual cash flows or sale of the financial asset, or (2) to manage risks associated with changes in liquidity or interest rates. Assets cannot be held for resale at time of investment.	Fair value; changes in fair value are adjusted through other comprehensive income and recognized in equity. (Initial recognition is at transaction price, rather than fair value)
Subsequent changes in categories	Are not permitted	Not permitted
Sale of investment	De-recognition of investment	All realized gains and losses are recognized in income

Source (FASB, 2011)

After reviewing and discussing the information shown in the tables 3 and 4, Marion and Robert are concerned about the effect of the proposed changes on the company's investments currently classified as "available for sale" and argue that the company may have to consider the potential effect on the company's future income.

Karin agrees that net income may become more volatile in the future if the stock market continues its current year trend, however, she points-out that the trend toward focusing on comprehensive income may mitigate the importance of the effect under the proposed changes. Karin promises to add a column to the tables to include the effect on net income and the balance sheet (statement of financial position) for each (a) the current and (b) the proposed accounting rules governing the measurement and recognition of investments. She will prepare and e-mail expanded tables to Marion and Robert after returning to her office.

Robert mentions that he recently heard that separate standards for private companies may soon be developed. He is aware that for some time, support for separate private company financial accounting standards existed and wants to hear about the current status of this movement as well as Karin's opinion regarding the outcome of this issue. Marion asks whether this could affect Fortschritt Company in any way.

PRIVATE COMPANY FINANCIAL REPORTING

Karin explains that in 2009, the American Institute of CPAs (AICPA), the Financial Accounting Foundation (FAF), and the National Association of State Boards of Accountancy (NASBA) sponsored a Blue Ribbon Panel on Standard Setting for Private Companies (BRP). The BRP was asked (a) to consider the needs of private company financial statement users, (b) to explore how accounting standards can meet those needs, and (c) to make recommendations to the FAF Board of Trustees. Initially, the BRP considered seven models – five of them based on U.S. GAAP (including a new standalone US GAAP for private companies) and two based on IFRS. Early on, the panel eliminated the IFRS models and the new standalone U.S. GAAP for private companies from further consideration. In January 2011, the BRP issued its final report and recommendations (BRP, 2011). In its report, the BRP recommends that U.S. GAAP should be modified and adjusted to better meet the needs of private entity financial statement users. The panel further recommended that immediate action should be taken to tailor U.S. GAAP to those needs.

Karin believes that these recommendations likely will lead to significant changes in financial reporting and cause significant differences between private company and public company financial statements. Robert wonders why the BRP chose not to recommend IFRS for SMEs, which was developed specifically for small and midsize companies, nor the development of a stand-alone set of accounting standards specific for private companies, similar to Canada's approach.

Robert asks whether this ultimately will affect Fortschritt Company, which is no longer a private entity. Karin explains that this may affect Fortschritt's financial reporting if, in the future, it acquires a private company that prepares its financial statements consistent with (different) private company financial reporting standards.

In light of Fortschritt's plans to acquire several private start-up entities during the next five years, Robert asks Karin to prepare a brief list of points that should be considered in planning, assessing, and executing acquisitions of private companies. Karin indicates that she will also include financial reporting issues that may arise during the acquisition and the subsequent consolidation of financial statements. She will have the information ready prior to the next board of directors meeting in two weeks.

At the end of the meeting, Karin indicates that the company is well prepared for the adoption of IFRS, assuming that the SEC decides to mandate some level of adoption. After the meeting is adjourned, Karin returns to her office to prepare expanded tables on investments, as discussed during the meeting. She also prepares some questions and answers on several related issues that may be of interest to the board of directors. She plans to offer a copy of these to Marion and Robert prior to the board of directors meeting.

ASSIGNMENTS

Please answer any questions assigned by your instructor. Include the proper support and references.

CONCLUSION

Proposed changes to accounting for investments and the advent of specific accountings standards for private entities is likely to affect the majority of public and private entities. The effect will be especially significant for companies that have significant investments in debt and equity securities, companies that are currently private and are planning to become public, and companies that are planning private entity acquisitions. Students should become aware of expected changes, the effect of these changes on the financial statements, and the strategies that executives may use to address the challenges and opportunities that arise. This case addresses a number of issues that may arise and can be utilized in class to introduce and discuss proposed accounting changes and their implications for companies.

REFERENCES

American Institute of Certified Public Accountants (2010). *Accounting Trends and Techniques. 46th ed. New York: New York.*

Blue-Ribbon Panel (BRP) on Standard Setting for Private Companies (2011). Retrieved on March 3, 2011, from http://www.aicpa.org/interestareas/frc/accountingfinancialreporting/pcfr/downloadabledocuments/blue_ribbon_panel_report.pdf

Financial Accounting Standards Board (2011). Accounting for Financial Instruments Summary of Decisions Reached to Date During Redeliberations as of August 10, 2011. Retrieved on August 20, 2011, from http://www.fasb.org/cs/ContentServer?site=FASB&c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156422130.

Financial Accounting Standards Board (2010). Proposed Accounting Standards Update. *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 81).* Retrieved on August 1, 2010, from http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820761372&blobheader=application%2Fpdf.

Financial Accounting Standards Board (2011). *Accounting Standards Update No. 2011-05.* Comprehensive Income (Topic 220): Presentation of Comprehensive Income. Retrieved on August 27, 2011, from http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175822630078&blobheader=application%2Fpdf.

Financial Accounting Standards Board (2011). *Accounting Standards Update No. 2011-04.* Fair Value Measurement (Topic 820). Retrieved on July 2, 2011, from http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175822486936&blobheader=application%2Fpdf.

AUTHOR'S NOTE:

This case deals with a fictitious company. Any similarities with real companies, individuals, and situations are solely coincidental.