CalCPA

1710 Gilbreth Road
Burlingame, CA 94010
(800) 922-5272
calcpa.org
calcpa@calcpa.org

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Ms. Hillary H. Salo
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

File Reference No. 2021-004, FASB Invitation to Comment, Agenda Consultation

Dear Ms. Salo:

The California Society of CPA's ("CalCPA") Accounting Principles and Assurance Services Committee (the "Committee") is the senior technical committee of CalCPA. CalCPA has approximately 42,600 members. The Committee consists of 54 members, of whom 45 percent are from local or regional firms, 32 percent are from large multi-office CPA firms, 12 percent are sole practitioners in public practice, 6 percent are in academia and 5 percent are in international firms. Members of the Committee are with CPA firms serving a large number of public and nonpublic business entities, as well as many non-business entities such as not-for-profits, pension plans and governmental organizations.

The Committee is writing to share its views on the Financial Accounting Standards Board's ("FASB" or "the Board") Invitation to Comment ("ITC"), Agenda Consultation.

We appreciate the Board's invitation for comments about the future standard-setting. Below we have provided our comments with regard to matters addressed in each of the four chapters of the ITC. We also provided our views on the projects currently on the Board's technical agenda in the section "Board Existing Technical Agenda."

Although the topic of private company financial reporting framework was not explicitly included in the ITC, we believe it does deserve attention as part of consideration of the future standard-setting activities. Our thoughts on this matter are included immediately below.

Standard Setting for Private Companies

It is our observation that many if not most private companies are unable to prepare financial statements that fully comply with the requirements of GAAP, primarily due to their complexity. Typically, these companies do not attempt compliance until and unless they have a requirement to conduct an audit of their financial statements. It is also not infrequent for auditors of these entities to have a shortfall of resources to timely learn and properly practice complex GAAP. As a result, where complex accounting areas are present, it is not uncommon to have errors or hard to support judgments present even in audited financial statements for private companies, which often comes to light when these entities are acquired or access public markets. This can be seen, for example, in the fact that many IPO companies report one or more material weaknesses due to lack of resources in their initial registration statement filings. Examples of complex areas are generally stock-based compensation, derivatives and other financial instruments, revenue recognition, and areas where the current accounting standards are primarily focused on needs of public company financial statement users.

In this regard, while we appreciate the efforts of the Private Company Council (PCC) to simplify certain aspects of private company accounting, we believe to date its efforts have not made a significant difference. In addition, as PCC authoritative guidance is layered *on top of* the existing GAAP, it means the body of authoritative literature private companies have to be aware of and follow is actually more, not less, than it is for public companies.

We believe there are different views on how this situation could be addressed. There is also no consensus among our Committee members. However, a substantive majority of our members believe a solution could be developed along the lines of IFRS for Small and Medium-Sized Entities (IFRS for SMEs). In other words, a separate comprehensive accounting framework that is substantially less in size and complexity than the full GAAP, and that private companies would be able to elect to adopt in its entirety.

We acknowledge that various stakeholders may have strong opposing views to the idea of separate GAAP for private companies. We recommend that the Board perform broad outreach across various stakeholder groups to determine if this may be a direction worth pursuing. Nevertheless, we hope that the Board recognizes that most small and medium size businesses see significant challenges to complying with existing GAAP requirements.

Chapter 1: Disaggregation of Financial Reporting Information

Among the areas related to additional disaggregation of financial reporting information, we believe the following should be priorities for the Board.

<u>ESG-Related Transactions</u>

Entities in certain industries effectively have a choice to either comply with emerging environmental regulations by taking measures to modernize their manufacturing, extraction or other processes to reduce footprint on the environment, to purchase ESG credits (certificates), or simply make additional payments in lieu of taking such measures. When this is the case, in addition to rule-setting for accounting for ESG credits purchased, we believe it may be appropriate to require disclosures to inform the users of the financial statements of the choices made by such entities.

<u>Cash Flow Statements</u>

The Committee members did not reach a consensus on whether entities should be required to use the direct method to report operating activities within the cash flow statements. Some members believe such reporting to be both feasible and useful to enhance the ability of the users of the financial statements to assess the entity's performance. Other members believe the additional information is unlikely to be of substantial benefit to the users, as oftentimes users can approximate how a direct-method cash flow statement would look like based on other information already included in the financial statements. Thus, these members believe the costs of preparing direct-method cash flow statements may not justify the expected benefits. In addition, the costs of preparation would likely also be significant for more complex entities.

Other

The Committee members do not believe there is a strong need to require all companies to report various disaggregation items listed in Chapter 1 of the ITC, beyond what already may be required in the financial statements and/or under the SEC rules in the entity's Management's Discussion & Analysis.

Chapter 2: Emerging Areas in Financial Reporting

Among the emerging areas in financial reporting discussed in Chapter 2, we believe the following should be priorities for the Board.

Derivatives

The topic of derivatives is, as to be expected, one of the more complex areas in today's GAAP. However, it is also a topic that one needs to be at least aware of in many transactions not commonly expected to lead to derivative accounting.

One reason for this is the emergence of new types of transactions where it can be difficult to apply certain aspects of the definition of a derivative, and certain of the available scope exceptions. For example, we have seen financing and licensing arrangements in the life science industry where a diversity in practice has been evolving. Some entities concluded the future payment obligations in these arrangements meet the definition of a derivative and do not meet any of the scope exceptions. Other entities concluded the definition of a derivative is not met due to there being an initial investment made by the counterparty, or because the arrangement falls under the scope exception in ASC 815-10-15-59(b). It is not currently clear whether differences in conclusions may or may not be reflective of differences in the underlying terms of the arrangements.

In these transactions, as well as other relevant transactions, judgments also have to be made as related to whether specific payment provisions represent freestanding instruments or embedded features. This determination can have a substantial impact on the ultimate accounting. The conclusions on whether a provision is freestanding or embedded can sometimes be based on obscure provisions buried in lengthy agreements, legal interpretations of a party's ability to separate components of a contract, and/or be simply a matter of convention (e.g. in asset acquisitions).

Entities are also required to consider derivatives when accounting for many types of specific arrangements. The scoping provisions of various Codification topics are set up such that derivative accounting, if applicable, will "trump" the other accounting topics. For example, this is the case with arrangements such as revenue contracts, research and development funding, contingent consideration in business and asset acquisitions, investments, etc.

Although the derivatives in the strict meaning of the term are the instruments that fall into the scope of Topic 815, the term "derivative" is often also applied to other instruments. For example, some practitioners refer to instruments in scope of Topic 480 as "Topic 480 derivatives." The presence of multiple frameworks where accounting is substantially the same as that for derivatives adds to the complexities.

Resulting from the above considerations, we find that the framework for assessing whether a particular instrument or provision requires derivative (or similar fair value) accounting is complex, can be highly judgmental, and the conclusions may often come down to existence and/or interpretations of "fine-print" provisions in contracts. While there are many examples in Big 4 literature, there is little guidance available for the newly emerging types of arrangements. As a result, there is a high risk of errors and inconsistent application, whereby similar transactions may be accounted for in a substantially different manner, that can also be misaligned with their economic substance.

We believe the recent instances of restatements by virtually all SPAC entities related to their warrants provide a relevant illustration of these factors. In effect, the entire accounting industry missed reaching appropriate conclusions on a frequently seen type of a financial instrument.

We encourage the Board to consider how both the definition of derivatives and the circumstances where the relevant guidance needs to be applied could be updated and simplified.

Digital Assets

We appreciate the efforts of the AICPA Working Group that has been developing and publishing interpretive guidance related to various aspects of accounting for digital assets such as cryptocurrencies. However, we believe their work has highlighted how the existing GAAP, and specifically, the accounting framework for intangible assets, does not fit the economic characteristics of these assets. This applies most specifically to aspects of subsequent measurement (cost vs. fair value), assessment of impairment, derecognition, and receivables and payables due in digital assets.

As our Committee has communicated in the past, we encourage the Board to add the accounting for digital assets to its agenda. We expect the use of these assets to continue to expand as more cases for their use are developed.

Financial KPIs and Non-GAAP Metrics

The Committee discussed the advantages and disadvantages of providing definitions of typical KPIs or non-GAAP metrics such as EBITDA, Free Cash Flow, Cash Burn, or others, as well as requiring these measures to be reported. While one could argue that including definitions in GAAP could improve comparability for users of the financial statements, we do not expect entities will focus their reporting on these measures as they would be defined. Instead, we expect entities will choose to report "adjusted EBITDA" and/or other adjusted earnings or cash flows measures, with adjustments that will likely vary significantly. A question will also arise and need to be addressed as to whether certain types of adjustments may or may not be appropriate in various circumstances.

Overall, a majority of our Committee members do not believe the Board should undertake a project to define or require KPIs or non-GAAP metrics to be reported. This can continue to be an area where guidance is provided by the SEC staff since we do not believe there will be a common framework that will be applicable to a majority of the entities.

If the Board chooses to undertake a project in this area, we believe any resulting guidance should not apply to private companies.

Government Grants

We also recommend the Board to add to its agenda a project on accounting for government grants to for-profit entities. GAAP currently has no framework to account for these transactions, which occur on a regular basis and can be expected to become more frequent in the future. While many entities analogize to IAS 20, others apply by analogy the provisions of ASC 450 on gain contingencies, or the recently updated ASC 958-605. We believe a project on government grants for-profit entities could close the existing "hole" in GAAP and also reduce the diversity existing in practice.

Chapter 3: Reduction of Unnecessary Complexity in Current GAAP

We do not believe most of the areas listed in Chapter 3 as potential simplification areas warrant to be a priority for the Board. Specifically, we do not believe there is a substantial need for projects addressing balance sheet classification matters, consolidation, or modifications of debt.

We do believe the existing liabilities vs. equity framework is overly complex and difficult for many entities, especially private companies, to apply, and should continue to be revised, with the ultimate goal of making accounting better aligned with the key economic characteristics of the specific instruments and the manner in which they are expected to be settled. Our comments on the topic of derivatives above partially address this area.

We do not expect there would be a significant benefit from adding commentary about materiality into each Codification topic.

Chapter 4: Improvements to FASB standard-setting process

We believe the contemplated improvements to the standard-setting process by the FASB are relevant and would be timely and welcome changes.

In particular, we support transforming the EITF into an interpretive body similar to the IFRS Interpretations Committee of the IASB. The EITF was most recently changed around 2009 from an independent body into an organization addressing issues delegated by the Board and whose conclusions need to be approved by the Board. While this change appeared appropriate at the time, it also resulted in the Task Force effectively losing its ability to handle the emerging issues in a quick fashion. Instead of a working task force, the EITF became more of a committee of executive reviewers and approvers similar to the Board itself. As we understand, the EITF progress on various issues is also dependent on the allocation of limited resources within the FASB organization to support the Task Force activities. As a result of a combination of these factors, the number of issues addressed by the EITF in recent years has been declining, while the time it takes for EITF to address and issue the authoritative guidance is the same and can also be longer than if the Board itself handled the issue. A reorganization into a working group tasked to make public interpretations of existing literature and recommendations for decision-making by the Board would enable to bring the EITF back into relevance.

We support linking relevant Basis for Conclusions paragraphs into the Codification. This would allow easier access to the background information including rationalization of the decisions reached by the Board.

We believe permitting entities to test application of new accounting standards can be a helpful practice. While this may mean some of the new accounting standards may be adopted by most entities at a later date, while certain entities may adopt them earlier, we do not expect these factors to be a significant impediment for users of the financial statements. We believe the benefit of obtaining earlier implementation feedback will likely significantly approve the Board's decision-making.

We encourage the Board to take advantage of possibilities offered by technology to improve access to the Codification. For example, where a particular paragraph is subject to pending changes, the Codification becomes more difficult to read. Modern technologies permit to present to the system user only the information that would be relevant to a specific entity (e.g. based on Internet cookies associated with the user's profile as related to his/her public or private entity, the noted elections to early adopt certain accounting standards, etc.). Technology can also be used to limit (or augment) standards depending on whether content is needed for private company or public company uses (so as to filter out, or highlight materials for which there are practical expedients available)

The language in the Codification is often difficult to navigate. Key challenges in our experience relate to confusing scoping provisions, abundance of cross-references to other Topics, Subtopics or sections, and the use of formalistic language. It takes a sophisticated user who is experienced and continuously practicing in this specific area to be able to comprehend what the Codification intends to say.

The original transition from the pre-Codification compilations of FASB *Current Text* and FASB *Original Pronouncements* into the Codification format excluded by design any substantive changes to the guidance. While we believe this was appropriate at that time, now it may be time to undertake the substantive revisions to simplify how the guidance is written and how it is organized, with the view to also make the authoritative guidance shorter and to have all guidance on a topic reside in one place. Currently the guidance represents a patchwork of writing styles and approaches from the past 70 years. As related to guidance reorganization, for example, it would be helpful to consolidate the guidance for financial instruments in one Topic instead of the current combination of paragraphs in Topics 470, 480, 815-40, and 825.

There may also be value in providing one fully indexed complete document of the Codification that is searchable and can be exported to a PDF format so that it's much more efficient to read and cross-reference.

Board Existing Technical Agenda

As it relates to the Board's current technical agenda, we in particular would like to encourage the Board to continue, with the view to issuing new authoritative guidance, the existing projects on:

- Accounting for assets and liabilities related to contracts with customers in business combinations
- Subsequent accounting for goodwill
- Improvements to indexation models for classification of instruments as equity or liabilities under Topic 480 and Topic 815-40
- Improvements to hedge accounting, including the portfolio layer method, and the reference rate reform
- Improvements to Topic 842
- PCC practical expedient for share-based payments
- Disclosures of government assistance
- Post-implementation review projects

As relates to post-implementation review, and in particular principle-based standards such as Topic 606 on revenue recognition, we want to encourage the Board to conduct broad outreach to private companies to learn about their experiences and the challenges they continue to face. This outreach could be conducted as part of the post-implementation review and would be helpful in determining potential additional desired practical expedients these companies could benefit from, as well as for future rule-setting processes.

We do not believe the existing projects related to improvements in the Conceptual Framework and disaggregation of performance information, should be continued.

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We thank you for the opportunity to comment on these matters. We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Sincerely,

Paul J. Peterson, Chair
Accounting Principles and Assurance Services Committee
California Society of Certified Public Accountant